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WHAT HAPPENS IF THE DOLLAR CRASHES

BusinessWeek

MICHAEL DELL'S EXTREME MAKEOVER

THE SPECTRE HAUNTING GE



INSIDE THE BUSINESS WAR AGAINST TAX REFORM

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THE BUSINESS WAR ON TAX REFORM

032 | Lobbyists hired by the likes of P&G and Schering-Plough have helped delay the White House's $210 billion in proposed corporate tax hikes. But companies' howls of protest that they're already overtaxed rate a closer look. | BW |

(COVER) PHOTO ILLUSTRATION BY RICHARD MICHIEL. PHOTOGRAPH BY BRAD TRENT; STYLIST: MEGAN TERRY; (ABOVE) MATT MURPHY

IN DEPTH

MICHAEL DELL'S DO-OVER

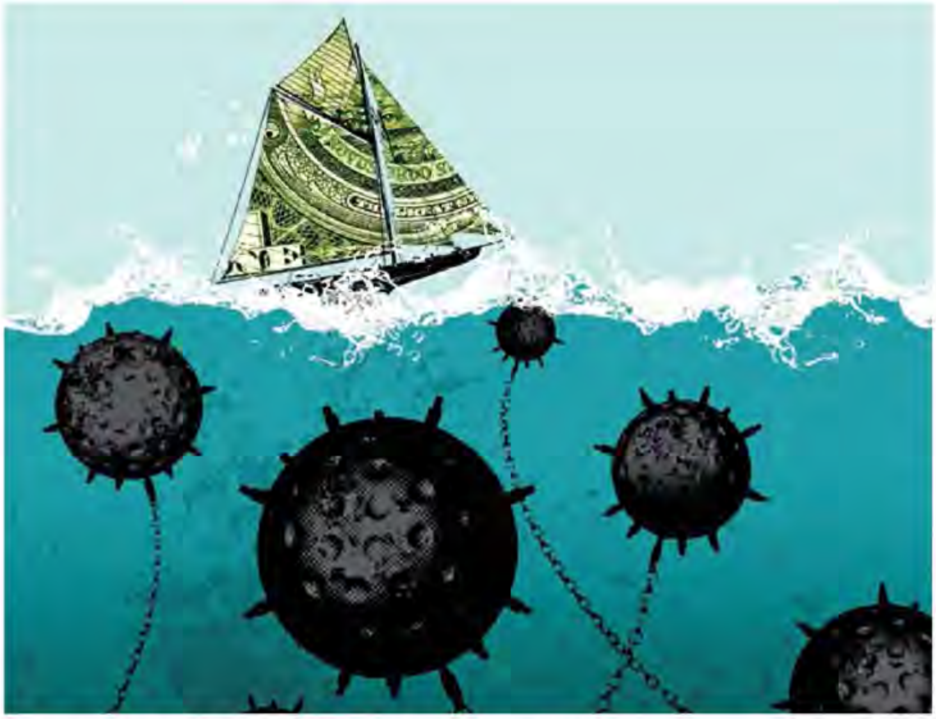
036 | Since returning as CEO in 2007, the founder has made sweeping changes in everything from personnel to core strategy. Now, as Dell buys Perot Systems for $3.9 billion, his turnaround plan turns out to be even more radical than previously thought. | BW |

THE HARD SELL FOR RETAILERS

042 | Smaller inventories. Fewer discounts. Expanded product lines. Go-against-the-grain risks. From Amazon's focus on product reviews to Neiman Marcus' "midday dash" sales, retailers are battling consumers' recent reluctance to spend. | BW |

THE SPECTRE HAUNTING GE

052 | The Omniscan dye made by GE is often injected into MRI patients to make images clearer. But for people with kidney disease, the dye might trigger a rare, sometimes fatal illness. That has stirred up a liability mess for GE's growing health-care division. | BW |



WHAT HAPPENS IF THE DOLLAR CRASHES

The currency has fallen 15% since March and may not be as disaster-proof as commonly assumed. If a bust does occur, trade wars, collapsed banks, and rampant U.S. inflation could result—and that's just for starters. | BW | PAGE 018



FORD ON FAST-FORWARD

Under Chief Engineer Adam Gryglak, Ford's Project Scorpion turned a tradition-bound engine development process into a 36-month sprint, with spectacular results. | BW | PAGE 056

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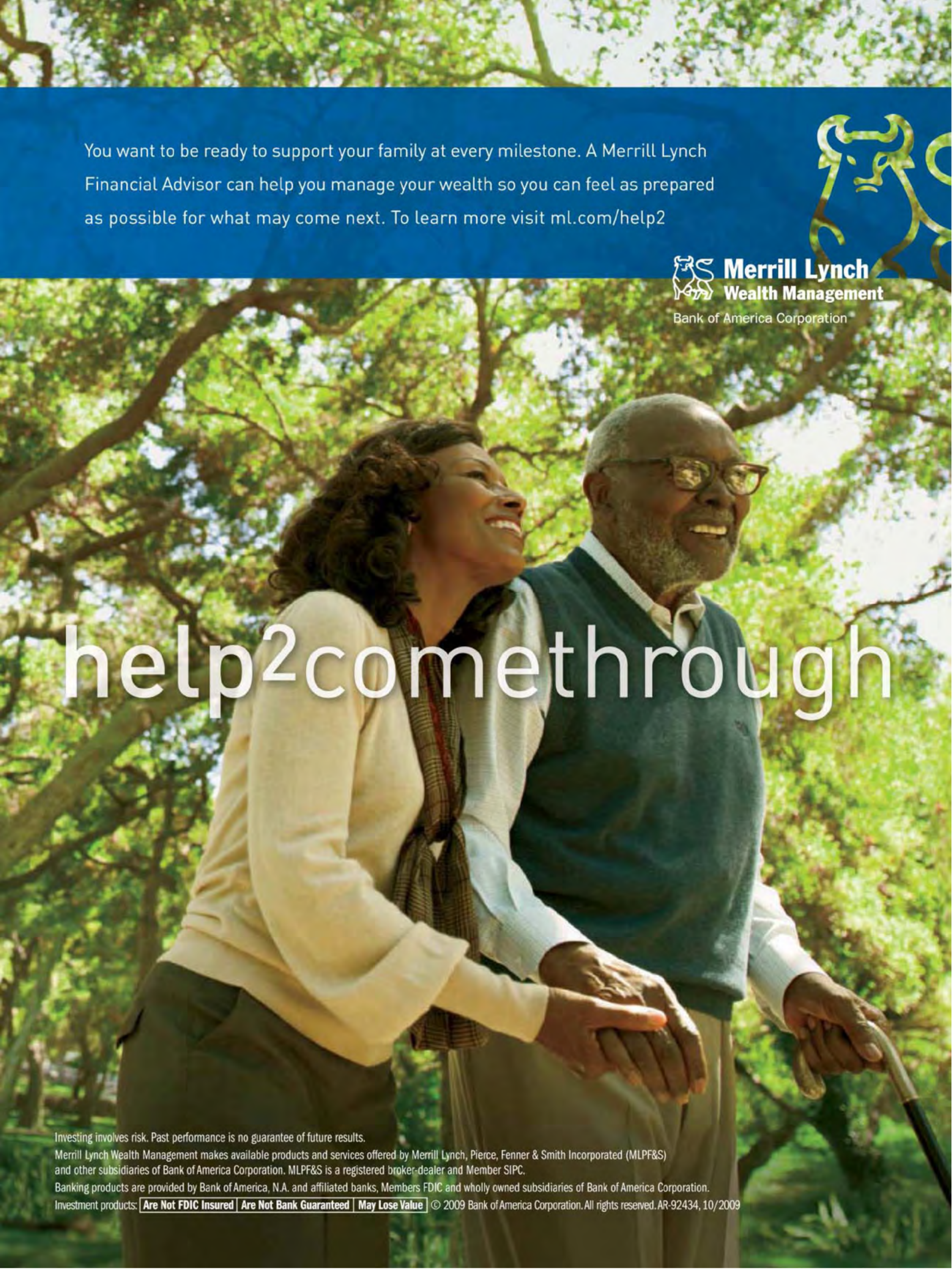
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Jack and Suzy Welch are off while Jack recovers from a back infection.

(L TO R) ILLUSTRATION BY GARY NEILL; ROY RITCHIE/WONDERFUL MACHINE


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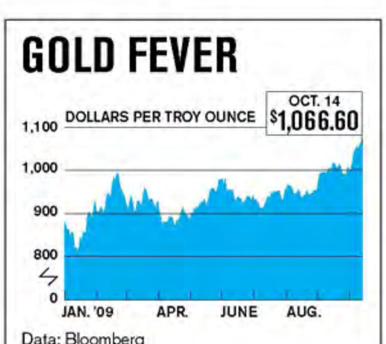
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ECONOMICS & POLICY

THE 10,000 MILESTONE

There's something mystical about Dow 10,000, especially as Wall Street climbs out of its recent abyss. And this week stocks continued their intrepid ascent, with the Dow closing at 10,015.86 on Oct. 14. Investors seemed excited by stellar earnings from **Intel** and **JPMorgan Chase.** The chip giant's third-quarter numbers handily beat its own forecasts, and its stock advanced 1.7% that day. The bank's stock price climbed 3.3%, to 47.16—almost three times its March low of 15.90—as it announced $3.6 billion in profits in the third quarter, up from $527 million in the same quarter last year. While most companies that reported by press time have surpassed expectations, **Thomson Reuters** estimates that **S&P 500** companies will collectively suffer a 25% year-over-year earnings decline, with much of the red ink in the materials and energy sectors. Meanwhile, the U.S. dollar continued its downward spiral, falling to a 14-month low vs. a basket of six major currencies.

|BW| PAGE 018 "What Happens If the Dollar Crashes?" and PAGE 024 "Pain Now, Profits Tomorrow"





Going up on the Big Board: Strong earnings pushed the Dow over 10,000

HEALTH REFORM ADVANCES

Congress took another step toward healing the health-care system on Oct. 13 when the all-important **Senate Finance Committee** voted 14-9 in favor of a reform bill that would cost $829 billion over 10 years. After intense, months-long negotiations, the bill was able to garner one Republican vote, from **Senator Olympia Snowe** of Maine. The insurance industry is lambasting the bill as worse than no reform at all because of a weak requirement that everyone buy insurance, while congressional liberals are angry that Finance jettisoned the creation of a government-funded insurer, or "public option." The bill must still be reconciled with a more liberal plan approved by the **Senate Health Committee** in July; the full Senate is expected to start debating the proposals the week of Oct. 26.

|BW| PAGE 028 "Twisting the Arms of the Uninsured"

SKILLING WINS ONE

Ex-Enron CEO Jeffrey Skilling has had a long run of ill fortune: A jury found him guilty of fraud in 2006, a judge handed him



Enron's Skilling: The Supreme Court will hear an appeal of his fraud conviction

(LEFT) RICHARD DREW/AP PHOTO; (RIGHT) STEVE UECKERT/HOUSTON CHRONICLE/PSG; CHART BY DAVID FOSTER

a 24-year sentence, and a federal appeals court upheld his conviction. But on Oct. 13 the **U.S. Supreme Court** agreed to take a look at his case. Skilling complains that it was unfair to try him in Enron's hometown, Houston, where so many victims of the collapsed energy giant live. And he says that one charge on which he was convicted, "honest services" fraud, is unconstitutionally vague. If he prevails on his first claim, he'll get a new trial; a win on the second may simply result in a reduced sentence, since he was convicted on other charges as well.

LIGHTS OUT FOR A UTILITY

As quickly as you can flip a switch, **President Felipe Calderón** on Oct. 11 shut down one of Mexico's worst-run state-owned companies—and with it a powerful and allegedly corrupt union. Riot police surrounded installations of **Luz y Fuerza del Centro,** which distributed electricity to one-fifth of all Mexicans, in Mexico City and surrounding states. The move took the **Mexican Electrical Workers Union** by surprise after a labor vote marred by alleged fraud. Calderón must lay out up to $1.5 billion in severance to the company's 40,000 unionized workers, but that pales in comparison with the $3 billion a year the government had been paying to subsidize the company, which the President said was plagued by "theft, technical failures, corruption, or inefficiency." Another state-owned outfit, the **Federal Electricity Commission,** will lend some 3,500 workers to keep the juice flowing. Polls show 70% of Mexicans applaud the shutdown.

▸ **"Mexico's President Moves Against Monopolies" businessweek.com/magazine**



STRATEGY

OPTIONS QUESTIONS

Are companies granting lucrative stock options to executives while merger talks are in progress? And if so, is that a bad thing? *The Wall Street Journal* on Oct. 12 reported on an academic study describing a pattern of target companies awarding options to top brass before a deal is announced. The executives then cash in when the stock kicks up on the day of the announcement. The study claims that companies engaging in the practice won lower takeover premiums than those that didn't, thus enriching the lucky executives but shortchanging shareholders. The

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PCWorld

Sprint tested as the most reliable 3G network overall among U.S. carriers in a recent 13-city 3G performance test conducted by *PC World.*

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story has spurred debate: For example, John Carney of the Business Insider blog observes that such options give CEOs an added incentive to do a deal, and that shareholders would receive no premium at all if no deal is consummated.

CHINA ACCELERATES

Vroom! Passenger-car sales in China, which overtook the U.S. as the world's biggest auto market earlier this year, climbed 84% year-on-year to reach more than 1 million in September, a record. Chinese drivers were especially eager for autos with teeny engines—sized 1.4 liters or less—because they qualify for state subsidies. Overall vehicle sales, including trucks and buses, jumped 78%, to 1.33 million. Meanwhile, just days after **General Motors** said on Oct. 9 that it's selling the **Hummer** brand to Chinese heavy construction maker **Sichuan Tengzhong** for $150 million, its Shanghai joint venture announced plans to roll out a Chinese Chevy, the **New Sail,** aimed at the fast-growing small car segment.



A Chrysler line in Shanghai: China set a record for auto sales

ZHANG ZIPING/IMAGINECHINA/AP PHOTO

LEADERSHIP

BRUCE WASSERSTEIN DIES

The legendary financier, who lucratively traversed decades of market change, died on Oct. 14, two days after being rushed to the hospital with an irregular heartbeat. He would have turned 62 on Dec. 25. Wasserstein for the past four years was chairman and CEO of **Lazard.** From his beginnings as a whiz corporate attorney at **Cravath, Swaine & Moore** to leadership roles at **First Boston, Wasserstein Perella Group,** and Lazard, he was a central figure in some of the highest-profile deals in M&A history, including the frenzied bidding for **RJR Nabisco** in 1989, described in the bestseller *Barbarians at the Gate.* He had been advising food behemoth **Kraft** in its pursuit of **Cadbury,** and his net worth was recently estimated at $2.3 billion.

FINANCE

WHEW! WE SOLD PHIBRO

It just doesn't look good when an employee of a bank propped up by the taxpayers rakes in a $100 million bonus. So **Citigroup** on Oct. 9 dodged a political firestorm and found an eager buyer for its Phibro energy trading business: **Occidental Petroleum,** which agreed to pay a modest $250 million for a unit that earned an average of $200 million a year since 1997. Oxy also agreed to cover the compensation of traders such as Phibro chief **Andrew Hall,** who was due the $100 million. His stratospheric pay was a dilemma for Citi, 34% owned by the feds and still afloat only because of $49 billion in bailout funds.

"Pass the Buck: Citi Sells Phibro to Oxy" businessweek.com/magazine

-1.5%

Decline in U.S. retail sales for September

0.5%

Increase in U.S. retail sales for September, excluding autos

Data: Commerce Dept.

TECHNOLOGY

CISCO STRIKES AGAIN

The networking giant is richer than Croesus—and unlike most tech behemoths, it seems hell-bent on remaining a company that delivers 13% to 17% growth year in and year out. That's why it has gobbled up two companies in the past month, with $3 billion the apparent sweet spot. On Oct. 1 it bought videoconferencing outfit **Tandberg** for that amount, and on Oct. 13 it paid $2.9 billion for **Starent Networks,** a maker of gear used by wireless carriers to deliver data services to cell phones. Maybe one day Cisco can bring relief to frustrated **iPhone** users, given carrier **AT&T's** difficulty keeping up with massive mobile Net traffic.



In the face of an unstable economy and an uncertain future, businesses are concerned about how they will navigate the coming months and importantly, how to identify and plan for a new set of risks.

We believe that quality business insurance has never been more important, or offered more value. Equally important is a clear understanding of the changing risk landscape. We launched *Zurich HelpPoint* to focus all our efforts as a global insurance group on delivering what our customers need when it matters most. Much more than a contact number or a website, it is a commitment to deliver help.

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Through times of war and peace, through booms and busts, we've made this our mission—and we have nearly 5 million magazine readers and more than 10 million online users to show for it.

Now we get the chance to become even bigger and stronger, in collaboration with our soon-to-be new owner, Bloomberg LP, which signed a contract on Oct. 13 to purchase *BusinessWeek* from The McGraw-Hill Companies.

McGraw-Hill has been the most benevolent of owners for *BusinessWeek*. Under a succession of CEOs, and under the current leadership of Terry McGraw, the company has protected our editorial independence, cheered our accomplishments, and kept our focus on journalistic integrity and excellence. I know the decision to sell *BusinessWeek* was not an easy one, and I also know that—once the company decided to consider a sale—a central goal was to find us a home that shared these values. Bloomberg, already a global editorial powerhouse with the highest of standards and the strongest of journalistic values, is such a home.

I'm confident that you, the reader, will benefit from the global resources and strong vision of the Bloomberg team while being able, as always, to rely on the trustworthiness and editorial strength of *BusinessWeek* in print and online. We look forward to continuing to serve you—and continuing to make ourselves indispensable.

Stephen J. Adler

Stephen J. Adler
Editor-in-Chief

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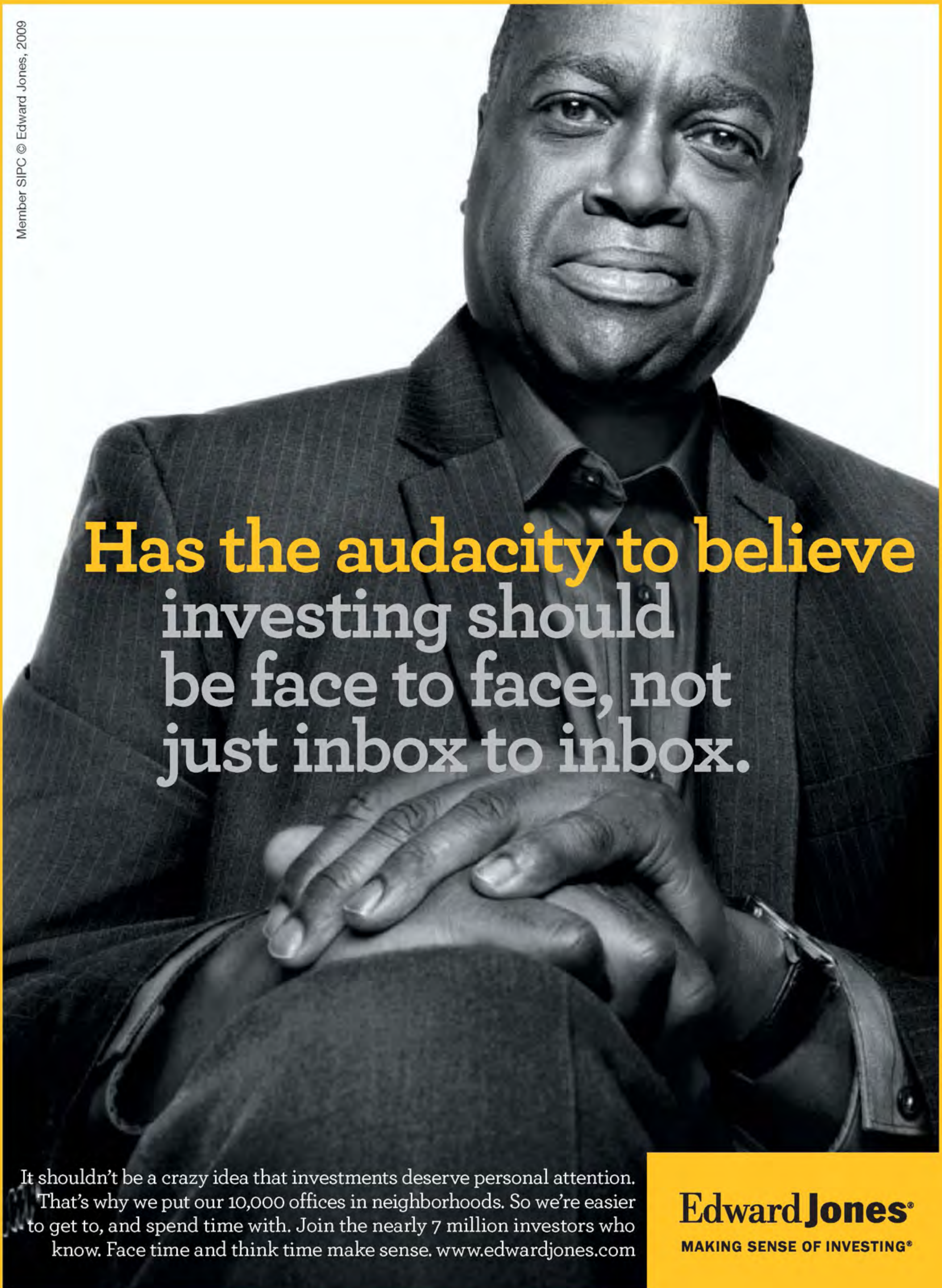
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PETER MORICI: BEHIND THE DOLLAR'S DOG DAYS

The continuing weakness of the dollar has led to what *The Washington Post* has called "a growing international chorus" to push aside the greenback as the world's reserve currency. *The Post* quoted a recent speech by World Bank President Robert Zoellick in which the former U.S. Trade Representative said: "The United States would be mistaken to take for granted the dollar's place as the world's predominant reserve currency." To better understand the dollar's dilemma, I talked with Professor Peter Morici of the University of Maryland, a former chief economist at the U.S. International Trade Commission.

MARIA BARTIROMO

Should the dollar be replaced as the world's reserve currency?

PETER MORICI

We don't have an official reserve currency. The reason people hold dollars, first, is habit. The second is that the dollar has historically been well-managed, until now. What is creating fear about the dollar are the huge deficits. So while China complains that the dollar shouldn't be the global reserve currency, it's really part of the problem.

In an op-ed piece for the *Baltimore Sun*, you said China and other countries have gamed the global currency system to their competitive advantage. How have they done that?

Well, China basically intervenes in currency markets, printing yuan, selling dollars to maintain an undervalued

(TOP) BRAD TRENT; (BOTTOM) STEPHEN VOSS

currency. [Fed Chairman] Ben Bernanke has said that [China's] currency system provides the equivalent of an export subsidy. I agree with him, and to my mind it's somewhere between 40% and 50%. The dollar should revalue against the yuan by at least that much. An undervalued currency is a form of protectionism. On top of that, China does a lot of things that make it difficult for companies to export into the country. Take, for example, solar panels. The two big markets for solar panels going forward are China and the U.S. But China requires that 75% of the contents of solar panels sold in China be made domestically. We don't.



Building solar panels in Hangzhou: China requires that 75% of the content be made domestically

You also suggest that the huge trade deficits that resulted in part from these currency games contributed to the Great Recession.
Exactly. The trade deficit requires Americans to spend more than they earn, or there will be inadequate demand for the goods and services they create. Essentially, when the credit bubble burst, [Americans] were no longer able to consume more than they produced, and the U.S. economy and the global economy collapsed.

Should the WTO have some mechanism to combat this sort of anti-free-trade behavior?
Currency manipulation is one of the most virulent forms of protectionism, and the original GATT [General Agreement on Tariffs & Trade] prohibited countries from using currency for competitive advantage. But with the dissolution of the Bretton Woods system in the early 1970s, the IMF [International Monetary Fund] really had no authority to regulate the behavior of countries that use currency to competitive advantage. Several industry groups in the past have suggested that Washington bring a WTO case, but the U.S. Trade Representative has declined to do so. The Bush and Obama Administrations have refused to act on the currency problem in a meaningful way.

How would you characterize the economy?
We're in a very tepid upturn, which is not what we would expect after such a sharp contraction. This quote "Great Recession" was as much a function of structural problems as it was cyclical maladies.

What are the structural problems?
During the last expansion, the dollar became chronically overvalued against the Chinese yuan. And the trade deficit soared. We also neglected our growing energy dependence. At one point we were paying almost $400 billion a year at an annualized rate for oil. At the same time the banks had access to a lot of money and had a compensation system and methods of accounting that gave rise to excessive risk-taking and booking profits that later turned out not to exist. And so until we straighten out the banks and do something about the trade deficit, we're going to continue to have chronic problems.

> **Until we straighten out the banks and do something about the trade deficit, we're going to have chronic problems**

What should be done about the banks? On the one hand Washington says, "Look, you need to lend more." On the other hand, it says, "We need you to get your capital levels up."
Well, we do need to increase capital requirements, but more than that, we have to look at how the banks compensate people. It wasn't just the big bonuses, it was the fact that the big bonuses were paid against profits that later turned into losses.

Doesn't talent flee and go elsewhere if you're not paying them adequately?
If everybody is operating under the same system, then no.

So treat the banking sector like it's a utility?
Like a regulated public utility. We wouldn't let Con Edison in New York pay its executives $10 million a year and then let the lights go out.

Are you worried about the Fed's exit strategy?
I'm not particularly worried about removing liquidity from the banks. The problem with U.S. macroeconomic policy is the Fed. The problem is Treasury.

You know, when I ask myself if America is on the ascent, I get depressed.
Oh, I get more than depressed. I think that we are in deep trouble, and we have had two bad Presidents in a row. And now that's becoming a problem. |BW|

Maria Bartiromo is the anchor of CNBC's Closing Bell and writes the blog, Maria Bartiromo's Investor Agenda, at investoragenda.cnbc.com

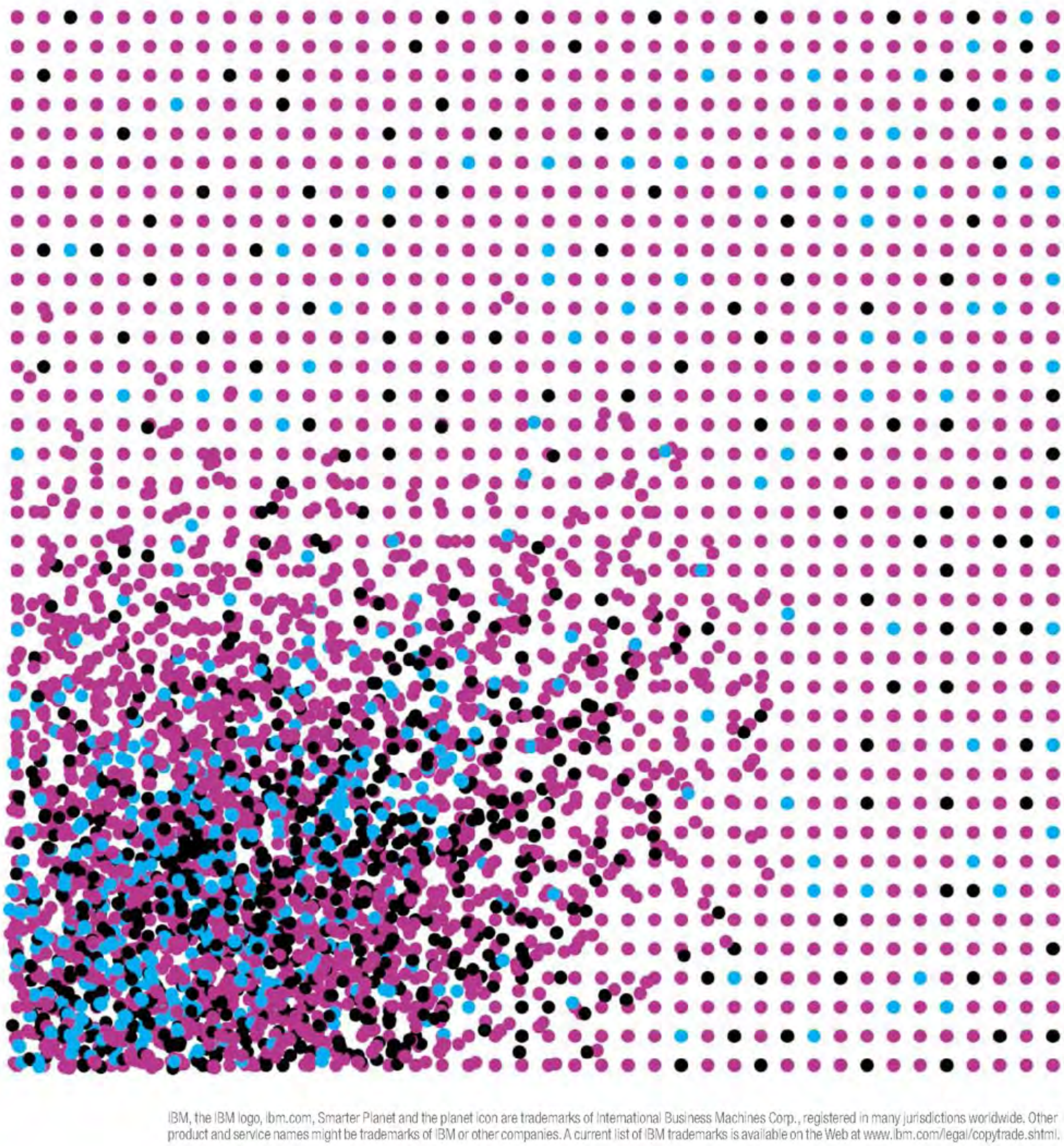
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THE WANING THREAT OF DEFLATION

The recovery is starting to reverse many of the trends putting downward pressure on prices and wages, paving the way for the Fed to begin tightening next year

Policy decisions by the Federal Reserve have always been driven by the balance between inflation and recession risks. The difference this time is the enormous consequences of misjudging that balance. On one side, policymakers face a possible surge in inflation if they withdraw too slowly the massive amount of stimulus they've injected into the economy. On the other, they must ensure the economy will not suffer a relapse, which could push down prices and wages, setting off a pernicious round of deflation.

Economists generally agree that, right now, deflation is still the bigger potential problem. But ever so subtly the balance of risks is beginning to shift away from deflation. That doesn't mean any move to tighten is imminent, as Fed Chairman Ben Bernanke reiterated on Oct. 8. But it does suggest that the end of the greatest monetary stimulus in history has finally appeared on the radar.

-1.1%

Annual rate of shrinkage in manufacturing production capacity so far this year, a record pace

Data: Federal Reserve

With inflation clearly headed down, caution will rule out policy tightening well into 2010. Inflation, using the Federal Reserve's preferred measure, was -0.5% in August, but that decline in prices is not true deflation. The drop is the result solely of lower gasoline prices. Still, core inflation, which excludes energy and food, has fallen to 1.3%, down from 2.7% this time last year. And because inflation typically continues to decline for at least a year into a recovery (chart), the rate may even breach the lower end of the Fed's 1% to 2% comfort zone next year.

Deflation is a concern because of the unusually large amount of unused labor and production capacity created by the deepest recession since the 1930s. That slack erodes pricing power and the ability of workers to command higher wages. By some estimates, real gross domestic product is now some 6% below where it could be if all workers and production facilities were fully utilized.

The recovery is starting to reverse some of these deflationary forces, including many of the excesses that have contributed to the downward pressure on inflation. Now that policymakers have stabilized the financial markets and demand, many businesses find that they have cut inventories, capital spending, and payrolls too deeply. They face inadequate stockpiles and the need to boost output and payrolls to meet even a modest pickup in demand. These conditions will take up some of the slack in the economy and put a floor under prices and wages.

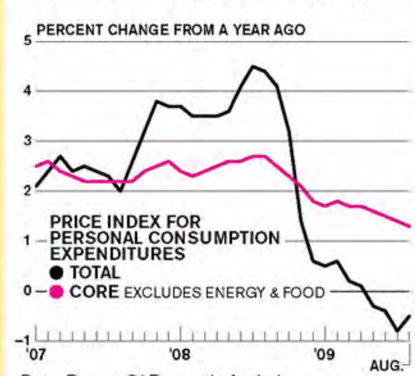
After slashing inventories by a record amount, businesses are shifting gears to a slower pace of liquidation. That means output is increasing, which will be evident in the report on third-quarter GDP on Oct. 29. More production is putting some of that excess capacity back into use. Factory operating rates, while historically low, turned up in July and August.

Plus, there's less excess capacity to soak up. The volume of equipment and productive facilities has shrunk, especially in manufacturing. Economists at JPMorgan Chase estimate that outlays for business equipment and software have been cut so sharply relative to the rate of depreciation that the U.S. capital stock will decline in 2009 for the first time since World War II. This shrinkage may partly reflect the credit boom, which fueled demand and created a lot of production capacity that is now worn out or obsolescent.

Slack in the labor market is sure to take a long time to absorb. Still, the 8 million jobs lost since the end of 2007, including the Labor Dept.'s latest benchmark revisions, have taken payrolls to unsustainably low levels. When demand was falling, businesses could squeeze out huge productivity gains from slimmer payrolls. But with demand now increasing, companies cannot sustain the 6% productivity growth of recent quarters. Soon they will need to add workers.

These emerging trends are still a far cry from those that would be associated with inflation concerns and Fed tightening. But the recovery is slowly creating conditions that will stem deflationary pressures and allow the Fed more leeway to start reversing its actions of the past year. |BW|

CORE INFLATION WILL CONTINUE TO DRIFT LOWER



Data: Bureau Of Economic Analysis, IHS Global Insight

BRAD TRENT; CHART BY DAVID FOSTER

NUMBERS

THE WORLD'S FACTORIES ARE HARDLY HUMMING

By Tara Kalwarski/Charts by Ray Vella

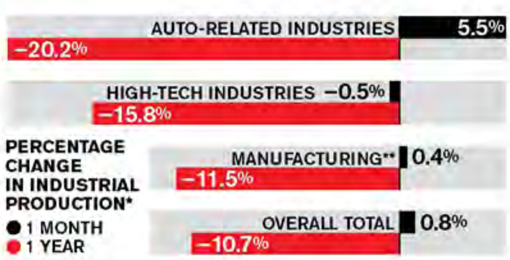
About half of the global economies are reporting double-digit drops in industrial production from a year ago. U.S. manufacturing, however, is showing signs of recovering.

Signs of Life: Improvements are appearing at U.S. manufacturers.

TRENDS REPORTED BY MANUFACTURERS		NO. OF CONSECUTIVE MONTHS
Imports	Growing	1
Backlog of Orders	Growing	2
New Orders	Growing	3
Prices	Increasing	3
Exports	Growing	3
Production	Growing	4
Supplier Deliveries	Slowing	4
Employment	Contracting	14
Inventories	Contracting	41
OVERALL	Growing	2

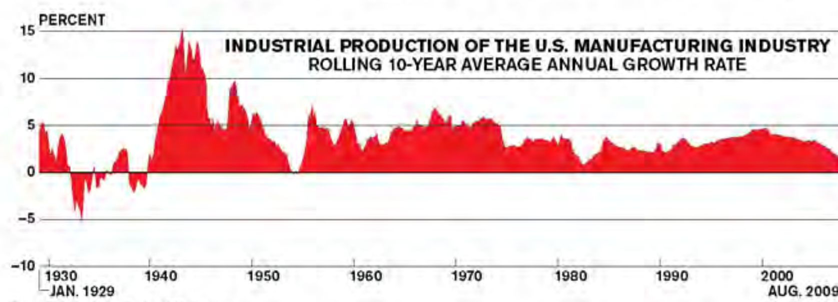
*As of September 2009
Data: Institute for Supply Management

Tech Is Tight: Manufacturing is up on a monthly basis; tech is still contracting.



*As of Aug. 2009 **Excluding high tech and auto-related industries
Data: Federal Reserve

Factory Fallout: Manufacturing, making up 85% of U.S. industrial production (utilities are 15%), produces less now than 10 years ago.

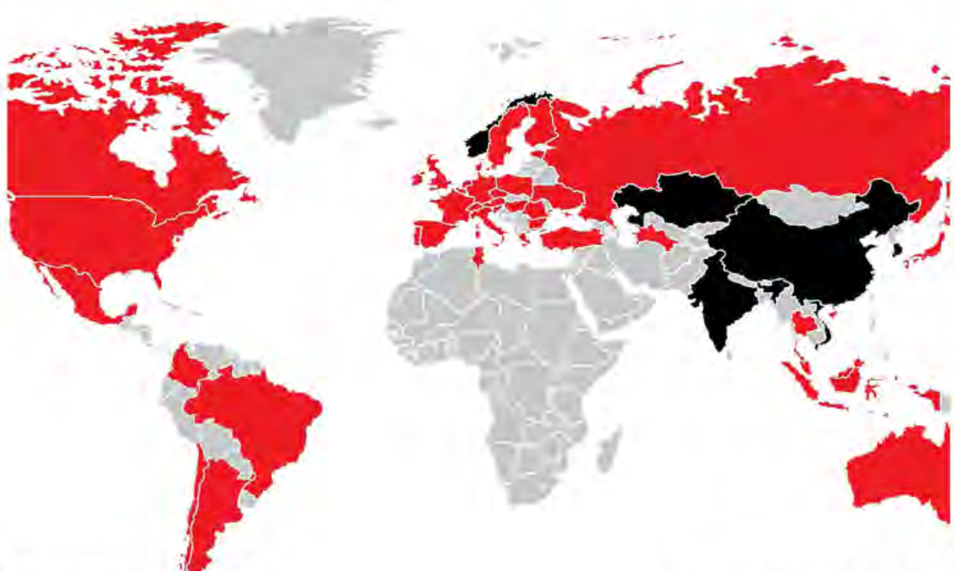


Data: Bloomberg, Federal Reserve

GLOBAL VIEW: ANNUAL PERCENTAGE CHANGE IN INDUSTRIAL OUTPUT*

Only a few countries (highlighted in black) have seen growth in the past year.

−1	ARGENTINA
−11	AUSTRIA
−14	BELGIUM
−7	BRAZIL
−11	BRITAIN
−19	BULGARIA
−7	CANADA
−4	CHILE
+12	CHINA
−7	COLOMBIA
−8	CZECH REPUBLIC
−17	DENMARK
−28	ESTONIA
−24	FINLAND
−13	FRANCE
−17	GERMANY
−9	GREECE
−10	HONG KONG
−20	HUNGARY
+7	INDIA
−1	INDONESIA
−2	IRELAND
−7	ISRAEL
−18	ITALY
−19	JAPAN
+2	KAZAKHSTAN
−14	LATVIA
−13	LITHUANIA
−8	MALAYSIA
−7	MEXICO
−10	NETHERLANDS
+3	NORWAY
0	POLAND
−5	PORTUGAL
−6	ROMANIA
−13	RUSSIA
+12	SINGAPORE
−20	SLOVENIA
+1	SOUTH KOREA
−11	SPAIN
−21	SWEDEN
−15	SWITZERLAND
−10	THAILAND
−3	TUNISIA
−9	TURKEY
−23	UKRAINE
−11	U.S.
+7	VIETNAM



Data: Bloomberg

*Most recent data as of Oct. 9, 2009

BTW

EDITED BY DEBORAH STEAD



AN ASIAN NANNY STATE UPS ITS FUN FACTOR

Singapore has long enjoyed a reputation as the cleanest and least corrupt country in Southeast Asia, which may be why multinationals such as GE Energy, Citibank, and Pfizer have made it their home base in the region. But while it offers the kind of security that corporate planners like, Singapore is also known for being prim and punitive—a place where chewing gum can't be sold and graffiti vandals have been sentenced to a half-dozen strokes of the cane.

Now the city-state is letting its hair down. For the past two years it has closed off streets during the last weekend of September to create a Formula One Grand Prix circuit—with drivers thundering through turns among the skyscrapers. At this year's event, Beyoncé, the Black Eyed Peas, and ZZ Top performed to crowds in a downtown park.

The next attractions: A pair of casinos. The $5.4 billion Marina Bay Sands, built by Las Vegas Sands, will open in early 2010 with two theaters, a science museum, a mall, and a convention center. The $4.2 billion Resorts World Sentosa, developed by Malaysia's Genting Group, will include six hotels, gambling venues, and a Universal Studios theme park featuring a *Shrek*-inspired castle.

Why all the fast cars, green felt, and roller coasters? With no natural resources, Singapore has been in a state of constant economic development since it was carved out of Malaysia in 1965. In the 1980s, its companies made a push into semiconductors. In the 1990s, it aimed to be a biotech hub, courting the likes of Novartis and Eli Lilly to open research labs. Recently it's been focused on wealth management and green technology. Singaporeans have "done quite a good job reinventing themselves and are looking to do that again," says Thomas Arasi, CEO of Marina Bay Sands. The hope: boost tourist arrivals to 17 million people annually, from 10.1 million last year, and double tourism receipts to $21 billion. But in keeping with Singapore's nanny-state image, the government will keep close tabs on the proceedings. To control wagering among locals, it will charge them $72 a day (or $1,440 a year) to get into the casinos. And problem gamblers can be barred from the tables if relatives put their names on a blacklist. *–Frederik Balfour in Hong Kong*

JASON COATES



Ottawa Senators' Chris Phillips (in white) wears the new helmet

A NEW HAT TRICK FOR HOCKEY PLAYERS?

Mark Messier can't recall how many concussions he suffered in a 25-year National Hockey League career. But the Hockey Hall of Famer remembers what it felt like to be busted in the noggin. "Numbing, disorienting. A feeling of being totally out of it," says Messier, who retired in 2004.

Now Messier and equipment maker Cascade Sports are peddling a new hockey helmet, the M11. It's designed, they say, with a single purpose: saving brains. A recent study suggests that former National Football League players are diagnosed with dementia at a rate as much as 19 times higher than average. And according to ThinkFirst Canada, a group dedicated to curbing brain injuries, research has found that 10% to 20% of teen hockey players may suffer concussions each season.

So far, Harvard's varsity hockey squad has signed up to wear the $120 M11s, which are equipped with energy-absorbing pads that helped the gear outperform conventional helmets by 26% in Cascade-run tests. But Messier is having a tough time courting NHL players. Just eight, including Chris Phillips of the Ottawa Senators, are wearing the M11 this season. The problem: The helmet has a slightly different appearance than standard models, and "in our sport, crazy as it sounds, looks come first," says Messier. His marketing strategy? Simple, he says. Persuade NHL players that brain health should trump vanity. The hope is that the youth market will follow the pros. *–Mark Hyman*

(TOP TO BOTTOM) PHOTOGRAPHS BY FRANK GUNN/THE CANADIAN PRESS/AP PHOTO; MOODBOARD/CORBIS

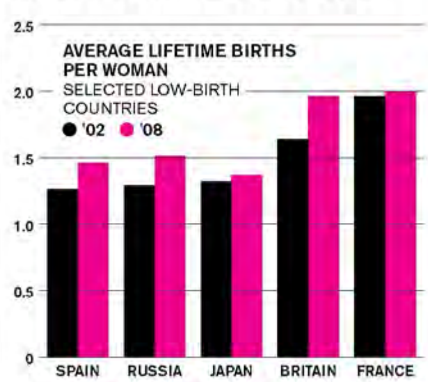
FOR LOW-BIRTH NATIONS, A BABY BUMP

A birth dearth is bad for business in the industrialized world. It means fewer young consumers and a shortage of workers whose taxes help support pensioners. So it's good news that total fertility rates—roughly defined as average lifetime births per woman—are recovering a bit in low-birth nations such as Britain, Spain, Japan, and Russia.

According to data released on Sept. 14 by the Population Reference Bureau in Washington, D.C., an uptrend that started around 2002 (earlier in some countries) was still going through 2008 (chart). Indeed, Taiwan is the only low-birth country whose total fertility rate is still dropping.

Japan offers subsidies and better child care to entice women to have more children. Russia gives mothers with one child $9,000 for each additional baby. Rising confidence in Russia's economy may be another reason for the improved fertility rate, says Population Reference Bureau senior demographer Carl Haub. But Russians still aren't making enough babies to stop the populace from dipping in the long term. The U.S.'s total fertility rate? At 2.1, it's high enough to keep the population from falling even if immigration ceased. *–Peter Coy*

A BIT MORE FERTILE



Data: Population Reference Bureau



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028 Apple goes after PC users

WHAT HAPPENS IF THE DOLLAR CRASHES

Trade wars could break out. Overexposed banks might collapse. And that's just for starters

By Peter Coy

The financial crisis taught us that markets can drop further and faster than anyone expects. Housing prices, for example, fell for three straight years starting in 2006, even though the conventional wisdom right up until the bust began was that prices would not fall even a little bit.

Let's apply some of our hard-won knowledge to the dollar, which is also supposed to be resistant to a bust. After weakening gradually since 2002, the greenback rose during the financial crisis last year. It has fallen roughly 15% since March as investors moved to higher-yielding currencies. The conventional wisdom is that at these levels the dollar is cheap and, if anything, due for a rebound. "Currencies don't go much more than 20% from their long-term averages in real [inflation-adjusted] terms. We're there already," says Michael Dooley, an economist who is co-founder and research chief of Cabezon Capital Management, a San Francisco investment firm.

But it's worth at least thinking about the possibility of a dollar bust. The reason the housing bust had such devastating consequences was a failure of imagination: Lenders, regulators, credit raters, and others simply couldn't believe that house prices would ever fall the way they did, so they were blindsided.

HOW TO PLAY IT 068

Let's imagine the dollar quickly dropped by a further 25% against each major world currency, roughly parallel to housing's unprecedented 30% decline. That would mean it would take $2 to buy a single euro. On the good side, U.S. manufacturers would find it easier to compete globally, and foreign tourism would boom in the U.S. On the bad side, inflation in the U.S. would zoom because of the rising cost of imported products. Americans would have even more trouble getting a loan as foreign buyers pull out of the debt market.

Because the dollar can be borrowed at near-zero short-term interest rates, it has become the fuel for speculation elsewhere in the world

Abroad, the cheap dollar would make it harder for other nations to export to the U.S., hurting their growth. China could face social unrest. Trade wars could break out. And there could be blowups at overexposed banks whose risk managers were sure no such dollar bust could happen. As investor Warren Buffett once said: "You only find out who is swimming naked when the tide goes out."

Federal regulators are monitoring banks for a wide variety of risks, including the threat of a dollar bust: "We're not looking quarter to quarter, we're looking hour to hour and minute to minute at what those risks are," says one regulator who requested anonymity.

From its spring peak, the dollar is down 11% against the Japanese yen, 16% against the euro, 21% against the Canadian dollar, and about 30% against the Brazilian and Australian currencies, which are benefiting from a commodity price spike. Against a broad market basket of all U.S. trading partners, and adjusted for inflation, the dollar has fallen 15% from its spring high (chart, page 20).



GARY NEILL



Behind the dollar's weakness are near-zero short-term U.S. interest rates. As they once did with yen, investors are borrowing dollars cheaply, then selling them to buy currencies of countries whose stocks and bonds promise better returns. The Federal Reserve is keeping the federal funds rate at a rock-bottom zero to 0.25% to stimulate the U.S. economy and heal the banks, but a side result is the dollar has turned into the preferred fuel for an international speculative play that is weighing down the greenback.

Another force driving down the dollar: continued U.S. trade deficits, which the U.S. is paying for by borrowing from the rest of the world. Some economists and traders believe that eventually the U.S. will be forced to devalue its own currency to make its global debt more affordable. While the trade gap has narrowed to less than 3% of gross domestic product in the second quarter from 6% at its peak in 2006, it is still high by historical standards.

Now, some of the foreign central



banks that have propped up the dollar seem to be getting cold feet. Instead of buying just dollars for their foreign-exchange reserves, they're diversifying into other currencies. The countries that reveal the composition of their reserve holdings put 63% of their new reserves into euros and yen in the second quarter, according to an analysis by Barclays Capital. Says Steven Englander, Barclays' chief U.S. currency strategist: "Their incentive is to try to do stealth diversification, not 'get me out of here at any price.'" (China, with more than $2 trillion worth of reserves, doesn't reveal what currencies in which it holds the funds.)

Obama Administration officials don't seem perturbed by the dollar's slide so far. A weaker dollar helps shrink the trade deficit by making American-made goods more competitive in world markets. Drew Greenblatt, owner of Marlin Steel Wire Products in Baltimore, which makes high-tech baskets for assembly lines, says he's winning orders from countries that are better known as exporters. Exults Greenblatt: "We are shipping ice to Eskimos."



Lip service? Geithner advocates for a strong dollar

This state of calm would vanish overnight, though, if the financial markets got a sense that the dollar's decline was starting to snowball out of control. At that point, the invisible "force field" protecting the dollar would fade away, says Martin D. Weiss, chairman of Weiss Group, a financial data and analysis firm in Jupiter, Fla. Says Weiss: "We would become more like ordinary mortals and more vulnerable to attacks on our currency."

In the bearish case, investors lose faith in the dollar, selling begets more selling, and speculators overwhelm official dollar support

The bearish case for the dollar is that the decline takes on a life of its own. Selling begets more selling. The world's central bankers and finance ministers intervene to prop up the currency, but speculators, having tasted victory, aren't scared off. Princeton University economist Paul R. Krugman once called this the Wile E. Coyote scenario, after the character in the Road Runner cartoons who runs off a cliff but doesn't start to fall until he looks down and sees there's nothing beneath his feet.

Speculation that the dollar is headed for a tumble can become self-fulfilling if traders rush for the exit. Ashraf Laidi, chief foreign exchange strategist at CMC Markets, a London currency and commodity brokerage, says "right now there is around a 30% to 40% chance we are going to see the dollar falling toward a crisis point."

Dollar bulls like to point out that the currency rallied strongly last year during the worst of the financial crisis. But Laidi says that was no show of support for the dollar or the U.S. economy. Rather, he says, investors retreated from all types of risk and put their money into the most liquid, short-term instruments they could find—which just happened to be U.S. Treasury bills, which are held in accounts all over the world. Agrees Barclays' Englander: "It wasn't a long-term bet that the U.S. economy would be the most dynamic in the world."

Currency traders don't put much stock in the statements of support for a strong dollar by Treasury Secretary Timothy F. Geithner and other Administration officials. They note that Treasury chiefs dating back to the Clinton Administration have said they support a strong dollar, yet the U.S. has not supported its currency through purchases since 1995.

If the dollar did tumble, import prices might rise faster than most economists now expect. New research by Columbia University economists Emi Nakamura and Jon Steinsson shows that the "pass-through" from a cheap currency to high import prices was underestimated because of poor data. In other words, inflation could emerge more quickly than is commonly believed. It would be disastrous for the economy if the Federal Reserve had to

THE DOLLAR: IS IT IN FOR A STEEPER SLIDE?



Data: Federal Reserve

*A broad index of the currencies of all major U.S. trading partners, weighted by their share of imports and exports, and adjusted for inflation.

JONATHAN ERNST/REUTERS/CORBIS; CHART BY DAVID FOSTER

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jack up interest rates to cool inflation or defend the currency while growth remained weak.

DERIVATIVE RISKS

A lower dollar makes Americans poorer by cutting the purchasing power of their currency. And there's no guarantee it would bolster U.S. industry, says David Malpass, president of New York research firm Encima Global. Malpass says the fall of the dollar in the late 1980s hurt rather than helped Detroit by giving Japan the buying power to strengthen its automakers. Says Malpass: "We can make ourselves poor enough that we can't import very much and we'll have balanced trade. But how would that be good for the United States?"

In the short run, the biggest risk would be the failure of some firm that made a highly leveraged bet that was vulnerable to a falling dollar. A dollar plunge would affect not only currency trades but also interest-rate derivatives and credit default swaps. Five big banks accounted for 88% of the credit-risk exposure from derivatives in the entire U.S. banking system in the second quarter.

No one knows whether the dollar is headed for disaster. But assuming the best is perilous. |BW|

–With Theo Francis in Washington

Business Exchange

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What Good Are Reserves?

After the Asian financial crisis of the late 1990s, emerging-market nations built up huge foreign-currency reserves. But new research by the International Monetary Fund shows that those reserves didn't help the countries weather this decade's crisis. A possible explanation: Countries feared that using any of their hard-earned reserves might be taken as a sign of weakness.

To read the IMF's analysis, go to **http://bx.businessweek.com/emerging-markets/reference/**

KOREAN EXPORTERS' WON ADVANTAGE

The currency has strengthened, but it's still below 2007 levels. That is making many Korean products a bargain



Hyundai Heavy Industries ship construction: Few orders for the industry

CHUNG SUNG-JUN/GETTY IMAGES

By Moon Ihlwan

SEOUL

Samsung, LG, and Hyundai Motor are all recording strong earnings this fall. Their products are winners, but the companies are getting a nice lift from the Korean currency as well. Although the won has strengthened a great deal against the greenback since March, it remains 20% below its level at yearend 2007. The current rate still makes many Korean exports look like bargains, especially against Japanese products, since the yen is trading at near all-time highs.

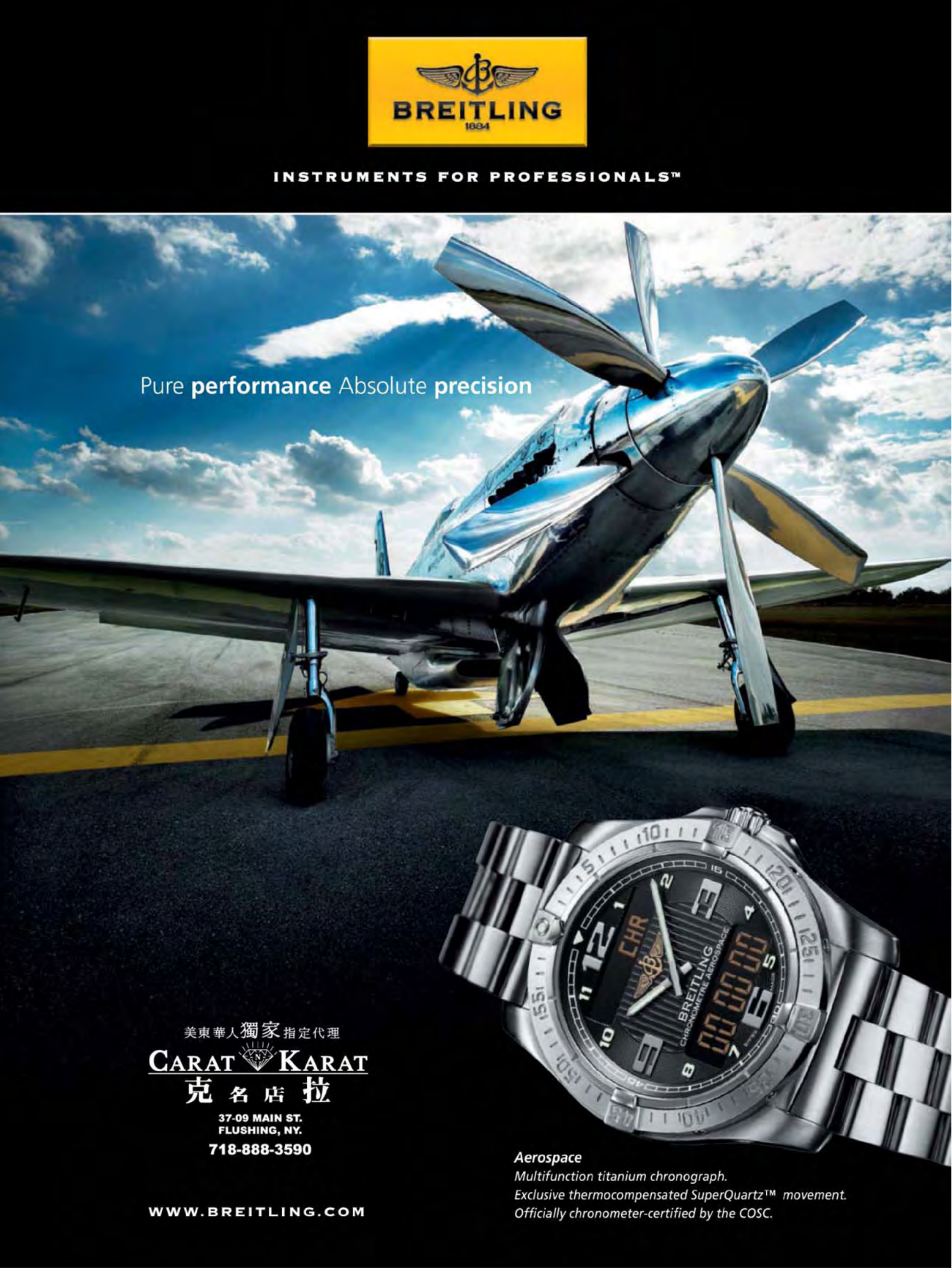
Why is the won staying so weak if Korea's brand-name companies are booming? Many exporters are benefiting from the misfortunes of the country's shipbuilders. "Had the huge level of shipbuilding orders in 2007 been maintained, the won would be much stronger," says central bank economist Cho Sok Pang. He says the won was extraordinarily high that year largely because of a shipbuilding boom.

In recent years ships replaced chips as the No. 1 export item from Korea, home of the world's six largest shipbuilders, including leader Hyundai Heavy Industries. Korean yards landed more than $70 billion in orders in 2007 and $48 billion last year. This year they may get one-tenth 2008's orders, the Korean Shipbuilders' Assn. reckons.

Shipping lines pay in dollars for the ships they order. As dollars flooded their coffers in 2007, the builders exchanged the greenbacks for won, which became increasingly scarce and expensive. The builders also bought won on the futures market, pressing the currency to rise further. When ship orders dried up, though, the industry's need for won rapidly declined.

Then the Lehman Brothers collapse triggered a global panic, and foreign investors retreated pell-mell from the Korean markets. The won, weakened already by the shipbuilders' woes, dropped 40% from its peak, one of the biggest crashes of any major currency.

Foreign investors have started buying Korean securities again, restoring some of the demand for won. But with the shipbuilders' once-gargantuan appetite for the currency all but gone, it's unlikely the won will reach its 2007 levels anytime soon. So Korea's exporters will continue to enjoy a won advantage, while Korean policymakers struggle to create a far less volatile currency. |BW|


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BANKS: PAIN NOW, PROFITS TOMORROW

By recognizing loan losses preemptively, companies are setting the stage for better earnings next year

By David Henry

Although investors have grown more confident about banks, earnings still look weak. The third quarter marks the 11th straight period in which the industry has delivered worse results than the previous year. Overall profits are expected to drop 28% from the same period in 2008, according to investment bank Keefe, Bruyette & Woods.

When will profits perk up? Despite the drumbeat of dire warnings about commercial real estate and consumer credit, the banks may be due for better earnings next year.

Much of the recent woe stems from banks recording the cost of losses before their loans completely rot. Fourth-quarter earnings likely will remain in the doldrums for the same reason. But the caution could pay off. By taking so much pain now, banks may be limiting the lumps they have to take in 2010. "I think they're going to be aggressive about recognizing problems so they won't have that drag on earnings [next year]," says Chris Kotowski of money management firm Oppenheimer.

Big banks are accounting for hefty losses, a process known as building up reserves. Kotowski figures Wells Fargo, which was slated to report earnings after *BusinessWeek* went to press, will rack up $6 billion of expenses in the third quarter for problem loans, more than double the amount a year ago. The company was expected to earn 38¢ a share, down from 48¢ last year. JPMorgan Chase, Citigroup, and Bank of America are adding to their piles of reserves as well. Kotowski figures reserves at the five largest U.S. banks will amount to 3.4% of their outstanding loans at the end of the fourth quarter—roughly twice the norm.

Thanks to the magic of accounting, the growing stash of reserves may eventually help juice banks' profits. That's because even if more loans go bad next year, banks won't necessarily have to build reserves to cover them. By the end of this year, they may have enough to deal with a lot of future losses. Assuming that's the case, earnings will look stronger in 2010.

28%

Estimated drop in third-quarter bank profits from the previous year

Data: Keefe, Bruyette & Woods

AN ABOUT-FACE

In the past regulators have raised eyebrows at such preemptive moves. The Securities & Exchange Commission and accounting rulemakers have discouraged banks from taking losses until they had real evidence—such as a history of delinquencies—that their loans wouldn't be paid in full. In 1998 the SEC forced SunTrust Banks to reverse $100 million in reserve-related expenses. The federal regulator was concerned the Atlanta-based bank was effectively dipping into current profits to make future periods look better, a practice known as cookie-jar accounting.

But the economy has changed since then. Now regulators, fearful of unanticipated losses lurking in loan portfolios, are urging banks to fatten their reserves. President Barack Obama and other leaders of the Group of Twenty nations formally called on regulators to allow bankers to be more "forward looking" in counting "expected losses." And the International Accounting Standards Board is currently drafting rules to do just that.

Of course, the question remains how much of the losses will ultimately materialize. Mortgages, credit cards, and other consumer loans are showing signs of stabilizing, although JPMorgan CEO Jamie Dimon warned on Oct. 14 that he expects consumer credit costs to "stay elevated for the foreseeable future." For many banks the biggest concern is commercial real estate, which analysts figure may not hit bottom for at least another year. But given just how much banks underestimated their losses at the beginning of the crisis, it's not improbable to think they would overestimate them toward the end of it. |BW|

MATTHEW HOLLISTER

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TWISTING THE ARMS OF THE UNINSURED

With mandatory coverage, just how high would the fines need to be to get most Americans on board?



Senators Baucus and Olympia Snowe (R-Me.) prepare to vote on Oct. 13

ROGER L. WOLLENBERG/UPI

By Catherine Arnst

How much is health insurance worth to you? That's a key question experts in Washington are trying to answer as Congress hammers out a health-care reform bill. Economists say the only way to cover most of the nation's 47 million uninsured is by instituting an "individual mandate" requiring everyone either to purchase insurance or pay a fine. The great unknown, however, is how high the penalty should be to motivate the uninsured to choose an insurance premium instead.

In the bill the Senate Finance Committee approved on Oct. 13—prodded along by Committee Chairman Max Baucus (D-Mont.)—there are no fines in 2013, the first year it's in effect. Individuals will have to pay $200 in penalties in 2014 if they forgo insurance, with the fine rising to $750 in 2017. Weighing that against an average yearly premium of $5,000, a healthy person might well decide to do without health insurance.

At least that's what insurers fear. America's Health Insurance Plans (AHIP), the industry's lobbying group, struck a deal with the Administration earlier this year to end the practice of denying coverage or charging more for preexisting conditions in return for an individual mandate. With access to 30 million new customers, many of them healthy, insurers figured they could afford to charge the same rate for all. Instead, says AHIP President Karen Ignagni, the low penalties create "a powerful incentive for people to wait until they are sick to purchase coverage."

Health-care experts generally agree that the penalties are too low to prompt most of the 47 million uninsured to sign up, but many disagree with AHIP's assumption that few will change their behavior. "We don't know what the magic number needs to be for the penalty to be effective," says Jonathan Gruber, an economist at the Massachusetts Institute of Technology. "But the fact is, most of us are law-abiding. No one riots over buying car insurance, it's just a fact of life. This could turn out to be the same."

$200 to $750

The range of annual penalties individuals might be required to pay if they opt out of buying health insurance

GAMING THE SYSTEM

The one real-world experiment in the U.S. seems to bear Gruber out. Massachusetts has been requiring all its residents to carry health insurance since 2007. In the first year the fine was $219, rising to $1,020 this year, about half the cost of a cheap insurance premium. An additional 428,000 residents have been covered as a result, and half signed up the first year. Last year, 86,000 people paid the fine.

Some Bay Staters are gaming the system, however. Dr. Marylou Buyse, president of the Massachusetts Association of Health Plans, says most of the state's insurers report cases where people sign up for insurance for a few months, have lots of medical procedures, and then drop coverage. "Their health-care claims tend to be two to three times higher than the average," says Buyse. "That's a good argument for having a fairly tough mandate."

Another argument, say economists, is that it's unlikely the rest of the nation will be as eager for insurance as Massachusetts. That state's insurance overhaul was passed with very broad popular support. In the South and Southwest, where both the numbers of uninsured and distrust of government run high, people may not be so enthusiastic.

For many of those people, the size of the penalty may not even matter—they won't want to buy insurance, period. So experts say it is important to educate people, particularly healthy twentysomethings, that buying a health policy is simply the responsible thing to do. |BW|

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CAN APPLE SPOIL MICROSOFT'S DAY?

The impending launch of Windows 7 is being seen by Jobs & Co. as an opportunity to lure PC users away

By Peter Burrows

The entire personal computer industry is gearing up for Microsoft's Oct. 22 release of Windows 7, by most accounts the best version of its operating system in years (page 71). Yet Apple, Microsoft's nearest competitor, is quietly planning to capitalize on the launch, too. "It presents a very good opportunity for us," says Philip W. Schiller, Apple's senior vice-president for marketing.

The Cupertino (Calif.) company sees Windows 7 as its best chance in years to win over longtime PC users. Millions of PC owners are expected to head to stores over the next year to replace their aging machines. The surge is expected to be unusually large because Microsoft's last operating system, Vista, was so poorly reviewed that many people simply stuck with machines running the eight-year-old Windows XP system.



ACME ILLUSTRATION

In the coming weeks, Apple plans to hit those computer buyers with advertising aimed at luring them to its Macs. It will make the case that Macs are less susceptible to viruses and are best suited to its popular iPods and iPhones. And look for it to poke fun at Microsoft for making XP owners go through an arduous process to upgrade to Windows 7—one that includes backing up all their files to an external drive, reformatting their PC, and then reinstalling all of their old programs, assuming they still have the CDs. "Any user that reads all those steps is probably going to freak out. If you have to go through all that, why not just buy a Mac?" says Schiller.

No question, Microsoft and partners such as Hewlett-Packard, Dell, and Acer will benefit from the Windows 7 debut. PC makers will be rolling out a raft of eye-catching new models—from $300 netbooks to sleek desktop computers with touch-sensitive screens. Microsoft downplays the hassles of upgrading to the new operating system and says most people are going to buy new PCs anyway, which means they won't install the software themselves. "For the vast majority of people that get Windows 7, most will move to new hardware," says Parri Munsell, Microsoft's director for consumer product management.

PC makers are likely to benefit from their machines being much cheaper than Apple's, especially given the soft economy. The average price of a Windows PC is $537, compared with $1,434 for a Mac, says analyst Stephen Baker of researcher PC Data. "I just don't think you're going to have a huge influx of people who have perfectly good XP machines deciding they need to buy an all-new Mac," he says.

Schiller won't say if Apple is planning to cut prices, which would certainly attract a flock of new buyers. He points out that the company already has programs for helping PC users switch; people who pay $99 a year for its One to One training program can bring their PCs to an Apple Store and have all their files transferred.

Schiller says the success of Apple's operating system is indicative of the changing fortunes in the tech industry. While less than 20% of Windows users have moved to the three-year-old Vista, more than 70% of Mac users have upgraded to the Apple operating system introduced at about the same time. He has similar hopes for Apple's four-month-old Snow Leopard OS. Says Schiller: "I expect Snow Leopard will have an amazing upgrade rate, and Windows 7 won't."

That's Apple—calm, cool, and confident that the tech world is marching in its direction. "We've been through these transitions before, and no matter how you look at it—it's still Windows," says Schiller. "When all is said and done, the Mac picks up share a bit at a time." | BW |

WINDOWS VS. APPLE

92.5%
Microsoft Windows' share of the U.S. PC market
Data: Gartner

6.6%
Apple's share of the U.S. PC market
Data: Gartner

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Business Aircraft:
Essential Transportation Tools

Negative characterizations of business aircraft, along with the need to dramatically reduce corporate costs as a result of the economic downturn, have convinced some companies to discontinue or reduce their use of business aviation. However, as employee ranks have been thinned and airline schedules pared, business aircraft have become more essential to companies that need to maximize their transportation efficiency, enhance key-employee productivity, and redouble their sales and customer support efforts. In tough economic times, business aircraft remain crucial to corporate success.

A Business Opportunity Machine

Barry LaBov, president and CEO of LaBov & Beyond Marketing Communications—a Fort Wayne, IN-based marketing, communications, advertising and training company—says he could not thrive without business aviation.

Fort Wayne has direct commercial flights to only four other cities, but LaBov has clients nationwide. He figures it often would take three days for him to do a business trip by airline: one to fly out, one to have a meeting and one to fly back.

LaBov first got involved in business aviation by chartering. Then his company bought a turboprop. To extend his reach, LaBov acquired a six-seat Cessna Citation CJ1 four years ago.

"I don't fly a 'private jet' or a 'luxury jet.' I fly a 'business jet,'" declares LaBov. "We fly from our community airport almost daily to reach clients all over the nation, and we average 4.5 passengers per flight. We do not fly with just one person aboard, whether it's me or anyone else."

"When a client in Washington, D.C. calls, we can be there in an hour and a half—and back in time for dinner with our families. Our CJ1 is a competitive edge, a statement to our clients and employees that we are committed to growing our business."

LaBov asserts that having a business airplane is more important than ever. "In this economy, my company has been more in demand because clients are saying, 'We need some fresh ideas; we'd like to talk to you.' So we are using the jet even more for new business opportunities than we have in the past.

"It is critical today to show your customers that you are committed, that you are not compromising your service or your focus," concluded LaBov. "I believe in being very efficient; we utilize all the modern communication tools.

"But there has to be a time when you meet a client in person," continued LaBov, "when you have that extended four-hour meeting to go over a product-launch strategy, or when you go to the client's office and are able to meet with a half-dozen people in a day, which is far better than having a 30-minute conference call. My mission is to be the best marketing communications company for our clients. For us to do that, we have to be physically around our clients to take care of them."

For LaBov & Beyond and thousands of other companies all across the United States and the world, business aviation makes that possible, which is why it continues to be a valuable and viable transportation resource. ◆



Barry LaBov, CEO of LaBov & Beyond Marketing Communications, which could not thrive without business aviation.



LaBov & Beyond's Cessna Citation CJ1 business jet enables the Fort Wayne, IN-based marketing, communications, advertising and training company to easily reach clients nationwide.

Cessna Citation CJ1: **The Right Size for Small Businesses**

Ever since the original Citation flew 40 years ago, Cessna Aircraft has been the expert at producing small, economical jets that meet the transportation needs of many smaller businesses. Today, the company has a complete line of small jets, including the Mustang very light jet and four models of the CitationJet (CJ).

The Citation CJ1, which typically seats two pilots and five passengers, can fly at nearly 450 mph and travel almost 1,500 miles nonstop.

Barry LaBov, CEO of LaBov & Beyond, said his company selected the CJ1 because "for us, it was the right size, in terms of the number of passengers it can carry, and it has the right range [for our missions]. Also, since it's a jet, it can get up and over the weather." ◆

Written by
Robert A. Searles
inspiracreative@
sbcglobal.net

Produced by Inspiratext
Creative Services, LLC
inspiracreative@
sbcglobal.net

Designed by
Dale A. Serena
dasproductions@
optonline.net

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INSIDE THE BUSINESS WAR AGAINST TAX REFORM

By Nanette Byrnes, Robert Berner, Ben Elgin, and Keith Epstein
Illustration by Matt Murphy

Lobbying by P&G, Schering-Plough, and others has stymied the proposed $210 billion in hikes. But the companies' tactics and past IRS battles raise troubling questions

Industry appears to have won its fight to postpone President Barack Obama's corporate tax reform initiative by stressing two themes: that tightening tax rules would cost U.S. jobs, and that it would hurt the nation's economic competitiveness. But those arguments can obscure the fact that some companies portraying themselves as defenders of the working person and the American economy are viewed by U.S. tax authorities as reluctant to fulfill their obligations under current law.

Companies such as Procter & Gamble and Schering-Plough have deployed legions of lobbyists to argue that business is the potential victim in the tax debate. Corporations contend that the 10-year Obama plan to raise taxes by $210 billion, much of it on income generated overseas, will give foreign-based competitors a devastating advantage. These companies emphasize that they already face a 35% income tax rate, higher than that of most other countries.

The lobbying has helped persuade lawmakers of both parties to postpone significant action on taxes until next year or possibly 2011. "The country's economy is seeing signs of getting back on track, but in many regards it's still in turmoil," says Senator Maria Cantwell (D-Wash.), a member of the Senate Finance Committee. "When it comes to our nation's tax code, we not only have to rein in abuses to the system but also look at how to keep U.S. businesses successful in a global marketplace ... and how we can facilitate job creation."

WHAT THEY REALLY PAY

When evaluating industry's competitiveness and employment arguments, though, it's worth examining two other factors: the rates U.S. multinationals actually pay and the companies' behavior under existing tax laws. Few large corporations pay the official 35% tax rate. According to a study of IRS data by University of Virginia law professor

George K. Yin, the average large company paid less than 27% in 2006, the most recent year for which data are available. General Electric, whose executives have criticized the Obama tax plan, has lowered its effective tax rate from 31% in 1999 to just 5.5% last year. That added more than $18 billion to GE's profits over the nine-year period.

A GE spokeswoman says the company's 5.5% tax rate was especially low because of losses at its GE Capital unit. GE expects its rate to rise this year. The company's main concern, the spokeswoman adds, is that the "Obama tax proposals are out of line with the tax systems of virtually every other major industrialized country and consequently would put U.S. companies—GE included—at an even greater competitive disadvantage."

Some of the loudest protests against stiffer taxes come from companies accused of abusing existing law.

As soon as then-candidate Obama began talking about closing tax loopholes last summer, Cincinnati consumer product titan Procter & Gamble scrambled to forestall any legislation that would hurt its bottom line. The Obama plan, announced in May, would address foreign earned income on which companies don't pay U.S. taxes unless they bring the money home. The White House wants to capture some of the foregone revenue by changing certain international tax-credit and deduction rules. The plan would also make it more difficult to shield some overseas investment income from taxation.

P&G in-house lobbyist James McCarthy, a former IRS lawyer, has made nearly 50 visits to lawmakers or their staff, a company spokesman says. McCarthy has argued that the tax changes would put P&G at a disadvantage because its foreign rivals pay less in taxes in their home countries. The Administration proposal "will result in a loss of jobs for Americans and serious negative impacts on the U.S. economy," according to a Mar. 24 letter to lawmakers signed by P&G and 198 other companies and trade groups.

TRIMMING TAX BILLS

A sampling of major corporations that have sharply reduced their tax rates in recent years (percentage drops from 2005 through 2008):

COMPANY	AVERAGE ANNUAL DECLINE IN EFFECTIVE TAX RATE	2008 EFFECTIVE RATE
Goldman Sachs	-69.7%	0.6%
Loews	-60.4%	1.2%
Centex	-55.9%	5.7%
Tellabs	-52.7%	2.4%
Macy's	-52.7%	2.7%

Data: Capital IQ, *BW* analysis
Note: Companies that responded to requests for comment generally said their low effective rates were aberrations.

LOBBYING EFFORTS

Like other major corporations, P&G focuses special attention on legislators from states where the company employs voters. Last spring, McCarthy met with staff in the office of Senator Olympia J. Snowe (R-Me.), a member of the Senate Finance Committee. He brought documents detailing the 512 jobs at P&G's Tampax plant in Auburn, Me. Higher taxes could put some or all of those people out of work, he contended. Snowe declined to comment on P&G's lobbying but said through a spokesman that she favors only those tax law changes that would not "put American employers at a severe competitive disadvantage."

About the same time, in a meeting at P&G's headquarters in Cincinnati, Representative Steve Driehaus (D-Ohio), whose district includes the city's downtown, heard what he calls "a very persuasive argument" that Obama's plans would hurt P&G. Under current law, P&G pays an effective rate of 25%. The company has attributed the lower rate, in part, to rules on taxation of foreign earnings that Obama wants to change. Jon Moeller, P&G's chief financial officer, spent 90 minutes telling Driehaus that Obama's foreign tax proposals would put P&G at a 15% to 20% cost disadvantage compared with certain rivals. Driehaus says the P&G arguments confirmed his independent view that any tax changes should be "taken up as part of overall tax reform, not piecemeal." That's Washington code language for a delay in any action.

Just down the street, in Cincinnati's federal courthouse, a different aspect of P&G's effort to reduce taxes on overseas income has been under scrutiny for seven years. The IRS has accused the company of using a Barbados subsidiary as an "abusive tax shelter" to claim more than $80 million in improper savings during 2000. The company allegedly routed hundreds of millions of dollars of sales to its Canadian operations through the Barbados subsidiary. P&G allegedly created fictitious losses to lower its taxable income. The sums at issue aren't huge for P&G, which had earnings last fiscal year of $13.5 billion



In the recession, jobs and global competitiveness are important to Senator Cantwell

on revenue of $79 billion. But the IRS was so concerned other companies were using the same shelter that in 2004 it alerted its auditors about the alleged P&G maneuver.

The IRS discovered the P&G arrangement in 2002, when it asked companies to report participation in tax shelters. In response to the IRS objection, P&G sued the government in 2006. The company lost last year and now is appealing. In its appeals brief, P&G argues that the losses generated through the Barbados subsidiary were not fictitious and that the company used proper accounting. "The [trial] court's holding disregards the clear text of the regulations," the company contends. A P&G spokesman declined to comment.





Representative Driehaus of Ohio (above) heard "a very persuasive argument" from P&G's Moeller

REPATRIATION DISPUTE

Schering-Plough, the Kenilworth (N.J.) drugmaker, has joined P&G in the Washington tax-lobbying trenches. Since the fourth quarter of last year its advocates have visited about 75 lawmakers or their staffers, a spokesman says. Meanwhile, the manufacturer of allergy drug Claritin and erectile-dysfunction medication Levitra is still fighting with the IRS over an arrangement that allegedly resulted in the company improperly deferring $473 million in taxes in 1991 and 1992. The arrangement involved bringing back to the U.S. $690.4 million in earnings from the company's Irish production facilities, according to filings in federal court in Newark. The money allegedly was routed through other subsidiaries in Switzerland to make the purported attempt at tax avoidance more difficult to trace, according to the Justice Dept., which represents the IRS in the case.

When a company "repatriates" overseas earnings so the cash can be used in the U.S., it is supposed to pay U.S. taxes on those funds during the year of repatriation. But Schering allegedly structured the deals to look like it was selling two complex financial investments to its Swiss subsidiaries in return for the cash. The government contends the company then improperly amortized the tax payments on the sales proceeds over a 15-year period, lowering its annual tax burden.

Schering declined to comment on the case, which went to trial this spring and is awaiting a judge's decision. In court papers, the company contends it followed all tax laws. "The IRS chose to make new rules," Schering argues in one filing.

In addition to its broad provisions, the Obama plan narrowly targets certain industries, including energy. The White House estimates that the repeal of nine tax breaks geared to oil and gas companies would bring in more than $30 billion over the next decade. One targeted provision currently allows oil and gas companies to expense immediately most costs associated with the preparation and development of new drilling sites, rather than the typical method of amortizing the costs over a period of time. The resulting tax benefit for oil and gas companies is estimated at $3.3 billion over the next decade.

Beyond the proposed energy-industry-specific changes, major oil producers are concerned about the Administration's efforts to bar certain accounting practices that allow them to lower their tax bills. The main technique is known as LIFO, for "last in, first out." Energy businesses buy crude petroleum at a range of prices. For accounting purposes, they often match sales of refined products with higher-cost batches of crude. That approach minimizes paper profits and decreases tax liability. The companies keep cheaper crude oil in inventory, where it may stay indefinitely.

Use of the LIFO method—which is legal—boosted ExxonMobil's $45 billion bottom line by $341 million last year, according to securities filings. Obama's 2010 budget seeks to repeal this accounting technique, a change that would net the Treasury more than $60 billion over the coming decade. ExxonMobil spokesman Rob Young declined to comment on any specific proposal but said "new taxes would make it more difficult for us to invest in energy development" in the U.S. Companies that would be affected by the alteration have swarmed Capitol Hill. A LIFO Coalition, formed in 2006, when the accounting method was first considered for repeal, has been showcasing smaller businesses that use LIFO, such as grocers and jewelers.

Armed with talking points provided by the American Petroleum Institute, the industry's lobby in Washington, company employees describe the risks to their livelihoods. Jim Ford, the institute's vice-president for government affairs, explains: "We're demonstrating in every way we can that these policies have an effect on real people's lives. It's not about some fat cat in the corner getting his bonus nicked." |BW|

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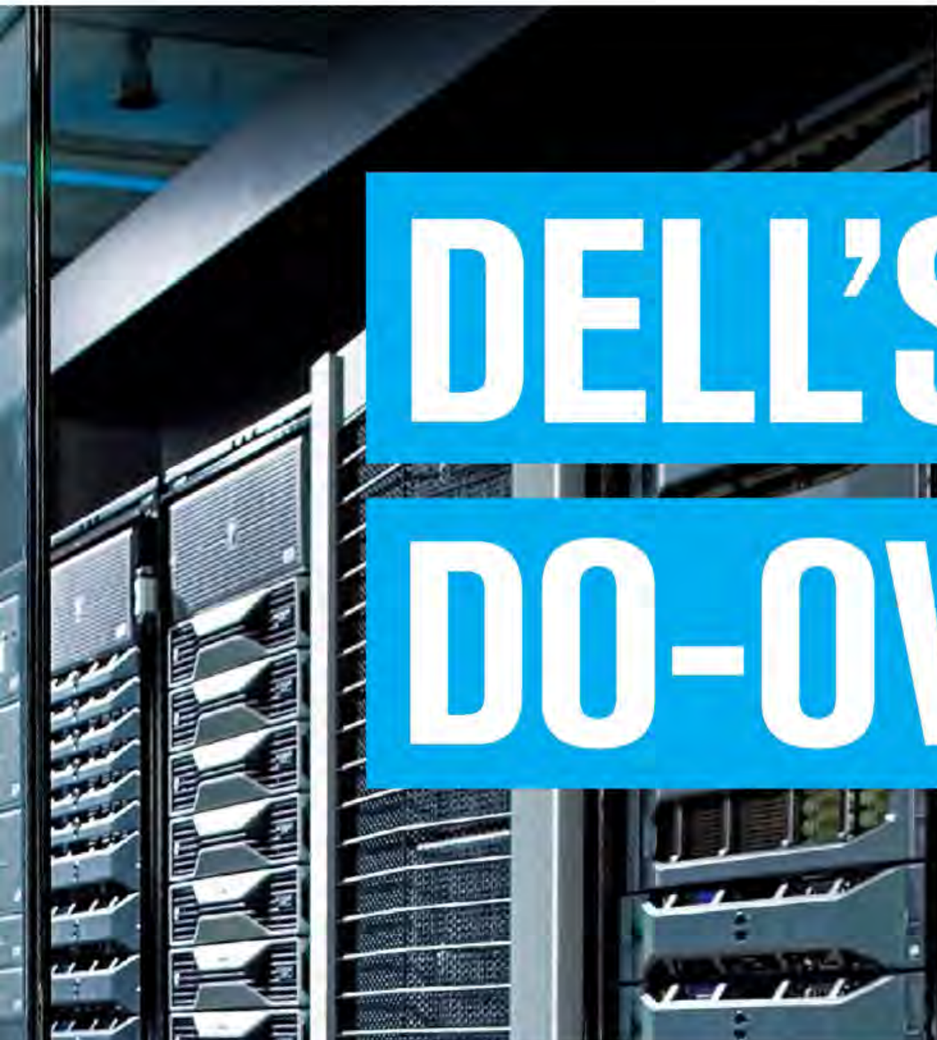
The energy industry warns that investors and retirees should worry about the Obama Administration's proposed tax changes. "Increasing taxes on the oil and gas industry could personally affect every individual shareholder of these companies or anyone with mutual fund investments, a retirement plan ... or Individual Retirement Account," says the American Petroleum Institute on its Web site.

To read more of the energy lobby's views, go to **http://bx.businessweek.com/us-energy-policy/reference**

(TOP) AL BEHRMAN/AP PHOTO; (LEFT) ALEX WONG/GETTY IMAGES



In his second tour as CEO, Dell is emphasizing customers over products



DELL'S DO-OVER

How Michael Dell is trying to change almost everything about the company he founded

By Cliff Edwards

Photograph by Matthew Mahon

When a wave of mergers swept the tech industry in 2004, Michael S. Dell promised investors they wouldn't see his computer company anywhere near a negotiating table. "When was the last time you saw a successful acquisition or merger in the computer industry?" he asked at the time. Five years later, it's a different story. Round Rock (Tex.)-based Dell is weeks away from closing its largest acquisition ever, a $3.9 billion deal for tech-services provider Perot Systems. The chief executive says more deals are likely, and this won't be the end of his changes in strategy. "Everything's on the table," he says.

And with good reason. The company Michael Dell started in his college dorm and built into the preeminent personal computer maker has fallen on hard times. As the center of the tech industry has shifted from the PC to the Internet, Dell has struggled mightily to find its place. While Hewlett-Packard, IBM, and other rivals transformed themselves in recent years by acquiring new companies and capabilities, Dell long stuck with its old playbook of cranking out PCs as efficiently as possible. It's hard to remember that in 2005 Dell was valued at $100 billion, or more than HP and Apple combined. Today, it's worth $30 billion, less than a third of its rivals' market values.

While such signs of struggle are clear to the public, what isn't apparent is the steady overhaul Michael Dell has been working on since he returned to the chief executive role in 2007. The 44-year-old has been making sweeping changes in everything from personnel and partnerships to acquisitions and distribution. He hasn't talked publicly about his comeback strategy before. But in interviews with *BusinessWeek*, the CEO made it clear he is determined to change almost everything about the company he started 25 years ago. "There's been a pretty ginormous shift in our business over the last several years," says Dell, dressed in a black suit and tieless white shirt in the sprawling conference room next to his office. "We can do, and must do, more."

He has installed an almost completely new management team to help with the turnaround. Seven of his ten direct reports are new to their posts, including veterans from General Electric, IBM, and Motorola. The company has been restructured to sharpen the focus on customers. And it is branching out into services, software, and new hardware categories, including smartphones and tablet-like devices. Sources say Dell is even preparing to add social networking features and music and video services to Dell.com. The old Dell is history, the CEO vows, and a new one is just beginning. "We're not trying to become like our competitors," he says. "We're digging our own path."

It's not at all clear Dell can pull this off. The old Dell succeeded because of its mastery of logistics

and the supply chain, allowing it to sell computers directly to customers at prices no rival could match. The new Dell requires completely different skills—flexibility, customer focus, and innovation. Leadership experts say changing a management approach is one of the toughest undertakings in business, particularly for a founder who has had early success. "He's got tremendous challenges ahead of him, because he's in an industry that itself is undergoing rapid, sweeping change," says Warren Bennis, chairman of the Leadership Institute at the University of Southern California Marshall School of Business.

A SLOW RESTART

Investors have given Dell virtually no credit for his work so far. The company's stock is off about 40% since the start of 2007, while Apple shares have more than doubled and HP's have risen about 10%. David Eiswert, manager of T. Rowe Price's Global Technology Fund, sold his last 140,000 Dell shares last fall because he thinks Dell has too many rivals in its PC business and doesn't spend enough on research and development to create stand-out technology. Dell is "saying, 'Don't worry, we have a lot of ammo,'" says Eiswert. "The problem is the invading armies have a lot more troops and a lot more ammo."

Dell is convinced he can prove the skeptics wrong. He understands that only a handful of former chiefs have returned to lead their companies to brighter futures. For every Steve Jobs there's a Jerry Yang, the Yahoo! co-founder who struggled after retaking the helm. Yet for Dell, this is an opportunity to prove himself, to show he not only can launch a great business but revive a struggling one. "What you do is walk outside the building, you pretend you're the new guy, and walk back in," he says. "You force yourself to do what you need to do."

He has already pulled off a more extensive overhaul than most outsiders realize. He still has a long way to go, but insiders say the CEO is as driven as ever, back to working the kind of hours he did when he started the company. Ronald G. Garriques, head of Dell's consumer division, fields questions from his boss after midnight these days. "I get these e-mails from him saying, 'Hey, Ron, I was on this Web site, and wouldn't it be really cool if our product does this or does that?'" he says. Roger L. Kay, founder of researcher Endpoint Technologies Associates, got a call from Dell one weekend late last year. "He wanted to know if I knew any people who might be good as head of marketing," says Kay. "On a Saturday when I'm repairing my garage door, he's making calls to analysts."

Dell hasn't had any time to waste since beginning his second stint as chief executive. It was January 2007 when Dell told his board he thought it was time to replace Kevin B. Rollins, his hand-picked successor. With the company losing share in the PC market and struggling with an investigation into its accounting practices, the directors agreed. Dell told them he was ready to step into his old job, but before they accepted, Donald J. Carty, the longest-serving director, stopped into Dell's office for a frank, one-on-one talk. "This is not going to be a stopgap thing," he cautioned the founder. "You're going to have to take the reins for a very long time." Dell pledged his commitment. "I'm going to care about this company when I'm dead," he told Carty. Dell's return was announced Jan. 31.

The business Dell took over was floundering. Corporate PC sales were slowing, while HP under the direction of CEO Mark V. Hurd was pulling consumers into stores—and away from Dell—with its stylish notebook PC designs. Dell suffered the consequences. It lost its position as the largest PC maker in the world to HP, and profits tumbled. Dell's net income dropped 28%, to $2.6 billion, for the fiscal year ending Feb. 2, 2007, while revenue inched up 3%, to $57.4 billion.

Dell's first move was to try to stop the bleeding in the consumer business. The head of the division left in February, and Dell started looking for a replacement by working his jam-packed Rolodex. He wanted someone who could cut costs and also guide the company's foray into retail chains around the world.

One name stood out: Garriques, head of Motorola's mobile devices business. When he and Dell had met years earlier, Dell had been impressed with how Garriques had guided development of the hit Razr phone. His broad experience dealing with top executives at retailers and wireless carriers would be invaluable as Dell tried to build a distribution network from scratch. Dell picked up the phone to call Garriques—no headhunters got involved—and quickly persuaded him to take the job. Dell's marching orders were simple: Create a profitable consumer business with designs that rival Apple's or HP's.

Garriques took a step back before moving forward. He killed a

DELL: THEN AND NOW

A look at Michael Dell's shifts in strategy:

Distribution	Dell used to undercut rivals on price by selling PCs directly to businesses and consumers. Now Dell is broadening its distribution, selling through retailers such as Best Buy and Wal-Mart and wireless companies like AT&T to appeal to a wider audience.
Innovation	Dell used to rely on Microsoft and Intel for most innovations, investing less than 1% of revenues in research and development so it could offer the best-priced PCs around. Now it's ramping up R&D to make its products stand out with innovative features and designs.
Acquisitions	In the past, Dell almost never did acquisitions, relying on growth in PC demand to boost its revenues. But with the PC market maturing, Dell is stepping up its dealmaking to push into tech services, storage, and other promising markets.
Management	As long as Dell focused on selling hardware, it could concentrate on the one objective of making those products as efficiently as possible. Now the CEO wants to sell software, services, and hardware, so he restructured the company around four customer groups to give each division head more autonomy.



KEY HIRE: ED BOYD

Chief Consumer Designer

The former Nike executive was recruited to jazz up Dell's computers

BRENT HUMPHREYS/REDUX

line of less-than-flashy consumer PCs Dell planned to introduce, called Mantra, and halted plans to copy Apple by opening more than a dozen Dell-owned stores. "The first order of business was to slow Dell's go, go, go mindset and stop to think about what we were trying to do," he says.

Then Garriques went hunting for a heavy-hitter to go up against Apple and HP. In March 2007, he approached Ed Boyd, a 42-year-old designer at Nike. Boyd had worked on sunglasses and running shoes but didn't have experience in computers. Garriques told Boyd he would have the opportunity to make design matter at Dell; Boyd jumped at the chance. "Here was a great company founded on the notion of customizing products and shipping them to people, yet it was missing the fact that people want to convey a sense of personal style with their products, too," Boyd says.

The changes sent a clear signal to Dell employees. The consumer business, long considered a professional dead end, was going to be a priority. What's more, Boyd launched experiments that showed it could be an exciting place to work. At one point, Boyd hatched a plan for customers to pay an extra $75 to get certain designs on laptops, which so unsettled Dell's manufacturing team that they balked. Boyd appealed directly to Dell, who green-lighted the move.

Later that year, Dell broke for good with its tradition of selling only direct to customers. It announced plans to sell its machines at Wal-Mart, in what the CEO called a "first step" in using retail stores to reach customers.

COMPLETE RESTRUCTURING

Even more far-reaching changes were in store for 2008. Dell knew he wanted to change the company's management culture, to get executives to jump on new business opportunities and take more risks, but he wasn't sure how to go about it. He turned to Brian Gladden, a 20-year veteran of GE, the bastion of modern management. In March that year, he asked Gladden to fly to Texas to talk about a job as chief financial officer overseeing day-to-day operations. Dell was in such a rush he didn't even tell Gladden he had the job before slapping an inch-thick sheaf of confidential documents on the table. "I said to myself, there's a lot of inside information here that I really shouldn't see," Gladden says. "But he was like this mad scientist saying, 'Brian, you can help with this, and you can help with this.' "

Gladden quickly slipped into an easy rapport with Dell. But the lack of structure at the massive company surprised him. "The processes, the tools, the culture here didn't support a $60 billion business," Gladden says.

He dove into figuring out how to change that, in consultation with Dell. After months of study, they became convinced the company had to be restructured around customers. It was a radical move: Most tech companies organize around the products they sell, such as computers or software. But Gladden and Dell thought that by focusing outward they could give top managers more responsibility and more flexibility to respond to clients. On Dec. 31, Dell said it would restructure into four customer groupings: consumers, corporations, small and midsize businesses, and governments and educational buyers.

With the global economy in crisis, almost no one took no-

tice. Dell's stock, which had topped $25 the previous August, closed the year at $10.24. It kept falling with the market, and dropped below $8 in February, off 70% in five months.

Still, in those dark days, Dell began to gain confidence his company finally had a solid foundation for the future. He saw his executive team quickly take to the new management approach, which was modeled after GE's. Leaders of each division are responsible for meeting financial targets and have broad authority to figure out how to reach them. The main beneficiaries have been the consumer, government, and small and medium-size business units, which in the past often received less attention as Dell focused on large corporations. "[It's] a different dynamic than [Dell] is used to," says Gladden.

In the small and midsize business group, led by Steve Felice, salespeople have been given incentives to offer a broad range of solutions, instead of just hardware. It seems to be working. Mark Konik, vice-president for technology at the marketing and ad shop GA Communications in Georgia, says Dell's regional sales manager showed up at his door six hours after he made an inquiry. Though the deal was only for $1 million, Dell offered to help integrate the company's Macs into the package and volunteered to talk to software providers VMware and Microsoft about including their products in the purchase. "The speed and competence Dell brought to the table in such a short period of time was really quite different," says Konik.

Garriques' consumer group has been making some dramatic changes. In October, to coincide with the launch of Microsoft's Windows 7 operating system (page 71), Dell will begin selling the world's thinnest notebook, at 0.39-inches thick. The Adamo XPS has a heat-sensing strip on the lip that, when swiped with a finger, glows white and automatically opens the aluminum lid. Garriques says the $2,000 computer will serve as a statement about Dell. "This isn't going to be a high-volume product for us, but it's going to be a product that says, 'Wow! Dell did that. What else does Dell have?' " he says.

With Garriques and the other division heads taking more control over operations, Michael Dell has been freed up to explore new opportunities. Over the summer, he had dinner at the Four Seasons in Washington's Georgetown neighborhood with James W. Breyer, a Dell board member and founding partner of the venture capital firm Accel Partners. Over steaks and red wine, Dell talked about prospects in mobile phones and other products. He then pulled out a half-dozen smartphone prototypes. "The way he laid it out, his thinking, led me to believe that in many ways the journey at Dell is just in the first or second inning," Breyer says. The company is expected to introduce its first smartphones early next year.



KEY HIRE: BRIAN GLADDEN

Chief Financial Officer

The General Electric veteran is bringing GE techniques to Dell

MATTHEW MAHON

Dell is beginning to show improvement in its financial results. In its most recent earnings report, the company handily beat Wall Street's expectations. Dell shares have doubled since their low in February, to $16, as hopes mount that the company will benefit from a surge in PC purchases tied to Windows 7.

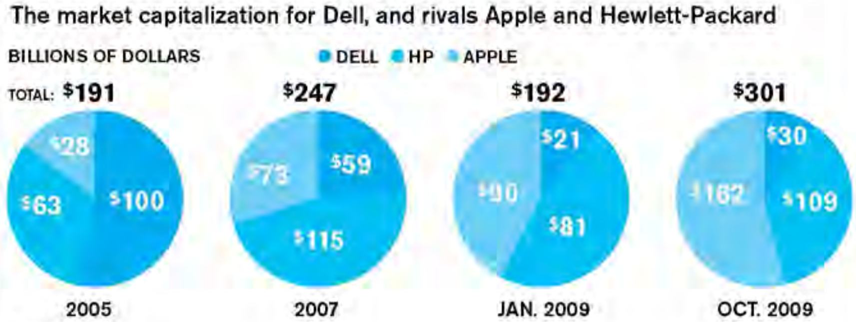
But Michael Dell is clearly looking for more than incremental improvements. He wants his namesake company to be the kind of force it was in the past, when it drove IBM out of the PC business and humbled industry giants like HP. "He's thinking, 'I'm going to make this company what it should be again,'" says Alex Mandl, a longtime Dell board member.

Rivals contend that Dell has waited too long to take the initiative. In an industry undergoing rapid consolidation, companies that haven't already positioned themselves to withstand the cyclical nature of technology will have a hard time thriving over the long term. That means Dell itself may be forced to merge with another company or become takeover bait. "Being a fast follower doesn't work in an industry that is moving faster every day," says Shane Robison, chief technology officer at HP.

Dell is more reflective than usual these days. During the interview in his conference room, he acknowledges he stuck with the one innovative idea of selling computers directly for too long. "Mea culpa," he says. But he says talk that he and his company aren't moving fast enough now is nonsense. "We're going to be stronger, faster, and more hyper than we've ever been," he says. "If you don't believe, then just sit back and watch." BW

DELL'S FADING FORTUNES

The market capitalization for Dell, and rivals Apple and Hewlett-Packard



Data: Bloomberg

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THE HARD SELL

By Jena McGregor
Illustration by Marc Burckhardt

How retailers are fighting for the hearts and minds of the new consumer

U.S. consumers at nearly every income level and spending stratum have pulled back over the past year, trading down from department stores to discounters or delaying purchases altogether. According to one poll, 60% of Americans say they're wearing clothes several times between washes to cut cleaning costs. And 72% say they now haggle before they buy some items, up from 56% two years ago, says C. Britt Beemer, chairman of America's Research Group. ¶ That frugality has retailers running scared as they near the all-important holiday season. Even if the economy picks up, some retail veterans think it could be 10 to 15 years before pre-bubble abundance returns. "They're looking at a new era," says Allen Questrom, a former CEO of J.C. Penney, Barneys, and Neiman Marcus who is now an adviser at Lee Equity Partners. ¶ So smart retailers are starting to rethink their approach. Instead of just slashing stock levels, slowing expansion, and discounting deeply, they're getting creative about managing inventory, adjusting product lines, and dumping their


Restoration Hardware's Friedman is selling pricier items this season

addiction to promotional pricing. A few risk-takers are even adding stores or raising prices. Over the coming weeks they will find out whether those initiatives will set them up to thrive during another tough season—or at least survive. Here are a few strategies they're using in this year's brutal sales battle:

Creating Scarcity: One of the biggest changes shoppers may notice this holiday season won't come on their first trip to the mall but their second. That size 6 sweater you were going to buy for your sister? It may be out of stock. "Retailers are not overcommitting on anything," says retail consultant Walter Loeb. "They can't afford to take the chance."

CEOs such as Myron E. Ullman III at J.C. Penney remember last year's pain all too well. "They didn't have to use the heart paddles on me, but it was a jolt," he says, recalling how the Plano (Tex.) chain missed last year's sales projections by $2 billion. This year he's holding back about 60% of inventory—both finished products and fabric—in warehouses, far more than the 20% held back last year, says Deborah Weinswig, a retail analyst at Citigroup. She calls Penney's efforts particularly sophisticated and aggressive. With more in warehouses, goods can be sent quickly to stores in need or cut into apparel styles that are selling well, avoiding the pile-ups that lead to heavy discounting or the empty shelves that result in lost sales.

Gap, too, heightened its focus on inventory management as it introduced a redesigned jeans line this fall, an ambitious effort to offer premium denim for $60 to customers used to paying up to $250 for boutique and department-store jeans. The line—which includes six women's styles, two to four "washes" (or shades), and six men's styles—meant rolling out a vast array of choices without knowing what would sell. So Gap North America President Marka Hansen and her team sought fabric that could be dyed into any of the shades and cut more of the denim after seeing which jeans sold best. Says Hansen: "We wanted to leave ourselves as much flexibility as humanly possible in reacting to what the customer voted for."

Kicking the Discount Habit: Retailers sideswiped by the recession last fall were left with little choice but to slash prices or cope with excess inventory. "There really was a bloodbath of markdowns and such an erosion of margins that it has created scar tissue" for executives, says Arnold Aronson, managing director of retail strategies at Kurt Salmon Associates and a former Saks Fifth Avenue chief executive.

Instead of just holding sales, Container Store CEO Kip Tindell moved this summer to permanently cut prices on a tenth of the chain's entire stock by an average of 16%. The lower prices, he hopes, will keep customers buying even when big sales aren't being pushed. But Tindell still anticipates the need for promotions. "Next year we're going to have to wean ourselves," he admits. "I don't know how we're going to do it."

Saks has also made moves that are leading to lower average prices. While the luxury chain's brand is still built on high-end merchandise, it's boosting its mid- and entry-level offerings, resulting in average prices that are down approximately 10%, says Citi's Weinswig. Saks CEO Steve Sadove says designers were initially hesitant to create more lower-priced goods. "The vendor community [in Europe] perceived this as very much an American problem." But now everyone from Gucci to Prada is using different fabrics and embellishments to lower costs. "The world has changed," he says.

Even promotions are different. Retailers are making them more targeted. Neiman Marcus' "Midday Dash" sales, launched this summer, lure customers via e-mails or Facebook alerts about deep discounts on select items. They are only available online for a two- to three-hour window, such as during the *NFL Monday Night Football* debut, when fashionistas might have extra time on their hands. The promotion follows the launch of popular luxury sites such as Gilt.com, which operate like invite-only online sample sales, selling goods for a 36-hour window at steep discounts. Neiman CFO James E. Skinner won't reveal sales data but says results have been better than expected. The recession, he says, "is forcing us to experiment."

Simplicity and One-Stop Shopping: Having the right array of products is critical in a world where stealing market share is crucial to growth. Neil Stern, a partner at retail consultant McMillan Doolittle, predicts that consumers will limit temptation by shopping under one roof. So

PHOTOGRAPHS BY THOMAS BROENING



Gap's Hansen is ensuring "as much flexibility as humanly possible"

chains are moving into new product categories.

Sears added permanent toy departments to 20 of its stores in August for the first time since the mid-1990s. While the chain has set up seasonal toy sections in the past, the permanent area is intended to bring back a recession-proof staple. Meanwhile, this year Best Buy tried out new categories such as patio furniture and electric scooters and is testing the sale of used video games in about 40 stores. "We've learned over time that our brand can go into more places than it used to," says Barry Judge, Best Buy's chief marketing officer, who speculates that one day the chain could "eventually end up [selling] electric cars."

While some retailers are broadening their offerings, others are dumping fringe products to help make store operations more efficient. Home Depot has cut back on styles of paintbrushes, grills, and even outdoor holiday products such as artificial Christmas trees and blow-up snowmen. Walgreen and Kroger have done the same, taking a page from Costco and Trader Joe's, where more selective product lines have helped the chains thrive.

Going Against the Grain: Risk-taking hasn't been a part of most merchants' strategies over the past year, and it isn't hard to see why. "Retailers live by daily sales, which tends to drive a mindset of living in the present," says Madison Riley, a senior partner at Kurt Salmon. But a few opportunists are pushing forward as others pull back. In an effort to reap higher margins and interact directly with customers, wholesaler VF Corp. is opening more of its own outlets. By 2012 the owner of such brands as North Face and Seven for All Mankind plans to get 22% of sales from its own stores, up from 16% last year. Competitors such as Jones Apparel Group, meanwhile, are closing stores. VF CEO Eric C. Wiseman says he does not expect a big recovery. But if it happens, "we'll be in a position to chase demand."

Furniture emporium Restoration Hardware also is taking risks. Instead of slashing prices, CEO Gary Friedman has hired artisans to take his furniture even more upscale. "If you're going to battle with the same goods you did in the last economy, you're probably going to lose," he says.

Friedman's idea, hatched after the crisis hit, has led him around the world four times in five months seeking unique designs while cramming product development into six months. The collection's debut this fall includes a $2,995 Italian chandelier and a $1,295 coffee table. "Am I nervous? Absolutely," he concedes. But he's willing to make the bet. "It's not what happens to you that matters. It's how you respond to it." |BW|



CEO Polet says customers are looking for more "authenticity"

FOR THE DOWNTURN, GUCCI DOWNPLAYS THE LOGOS

By Carol Matlack

The fashion house is going both upscale and down, but its famed GG bags are no longer front and center

PARIS

How do you sell luxury in a recession? If you're Gucci, you try to convince customers a handbag isn't just an accessory but an investment. The purse getting top billing in Gucci boutiques this season is the New Jackie, based on a style carried by Jacqueline Kennedy Onassis and marketed as a bag "to use and love forever." And GG bags, with the interlocking Gs, long the most visible face of Gucci? They've been banished to a small display near the luggage department. "In the last couple of years there has been a lot of impulsive buying," says Gucci Group boss Robert Polet. Now, "consumers are looking for more authenticity, more timeless products."

More timeless, but also more expensive. The New Jackie sports a price tag of $2,200 and up, or about twice what the GG bags cost. Asking customers to trade up during a downturn might sound crazy, but it's working pretty well for Gucci. The group's first-half 2009 sales were down 3.7%, vs. a 15% decline for the luxury industry, according to consultancy Bain & Co. While younger brands, such as Versace, have been forced to shutter stores, Gucci and rivals Louis Vuitton and Hermès are weathering the storm by trading on their deep European roots and reputation for fine handiwork.

Each of Gucci's eight brands—including leather-goods maker Bottega Veneta, jeweler Boucheron, and fashion houses Yves Saint Laurent and Alexander McQueen—has mapped its own anti-crisis strategy, hammered out between Polet and top managers. Yves Saint Laurent has trimmed the size of its collections while emphasizing understated French chic. Last summer it launched "New Vintage," a collection of 60 items based on iconic designs in its Paris archives. And it's putting a spotlight on craftsmanship, with ads showing close-ups of stitching on shoes and bags. During the boom years, luxury shopping "was about 'Let's have fun,'" says YSL chief Valérie Hermann. "Now, people are more interested in quality, how it will last."

Other brands are reaching out to price-conscious shoppers with cheaper products. Alexander McQueen is stepping up development of McQ, a midpriced line it launched in 2006 aimed at women in their 20s. McQ prices average just under $300 per item, 40% less than Alexander McQueen. The goal is to create momentum for the brand by cultivating an audience of enthusiastic younger shoppers, says Alexander McQueen CEO Jonathan Akeroyd. "We don't see this purely as a cost-cutting opportunity," he says.

ONLINE GROWTH

Although Gucci brand managers have leeway on strategy, Polet has imposed tough financial discipline. Ad budgets have been slashed and boutique openings put on hold. One result: More brands are stepping up their Internet presence. Boucheron, for instance, was one of the first high-end jewelry houses to create an online boutique where shoppers can select gems and other features to customize their purchases.

Still, some Gucci lines face a tough slog. Handbag makers may be able to pitch their wares as investments, but that might not work for clothing shops YSL and Alexander McQueen, whose customers won't wear the same dress year after year. Boucheron and YSL are further handicapped because they have few outlets in China, where luxury sales are growing robustly—some 14% during the first half. And even Gucci's strongest brands will have to adapt to China's rising power in the luxury world. Unlike Americans and Europeans, Chinese shoppers show no signs of logo fatigue. "Their motivation for buying is aspirational," says Bain analyst Claudia d'Arpizio. So those GG bags may end up at the front of the store after all. |BW|

ROBERTO FRANKENBERG

HOW AMAZON IS TURNING OPINIONS INTO GOLD

By Spencer E. Ante

The retail giant's focus on consumer-generated reviews and content has been a boon for sales

When Amazon.com first began letting customers post reviews of products in 1995, many people thought the Internet retailer had lost its marbles. Letting consumers rant about products in public was a recipe for retail suicide, critics thought. Now, almost 15 years later, customer reviews are as common as hyperlinks, and a retail Web site that does not have feedback loops is considered passé or irrelevant. In fact, more than 5 million consumers have posted tens of millions of reviews on Amazon.com, says the Seattle company.

Amazon's review program reflects a new reality for the way consumers shop in the Digital Age: The Internet has become the world's greatest research tool, and consumers hardly buy anything anymore without first getting the skinny online. Some 70% of Americans say they consult product reviews or consumer ratings before making a purchase, according to an October 2008 survey by Penn, Schoen & Berland Associates, a research and consulting firm. Amazon has played a central role in the change in consumer behavior by being the first successful Web retailer to embrace consumers' views. "What we try to spend our time on is harnessing customer passion," says Russell Dicker, Amazon.com's senior manager of community.



BRIAN SMALE

Amazon's Dicker with the wolf T-shirt that one joke review made into a hit

TAPPING THE COMMUNITY

Besides its review program, Amazon.com has created scores of community-based features on its Web site that help drive sales. In 1999 it unveiled Wish Lists, allowing people to share their favorite products. Hundreds of thousands of people have publicized millions of items on their lists. In 2005, Amazon.com launched customer discussion areas for specific products. And in 2006 the company created discussion hubs that allow consumers to gab about a wider range of topics, such as video production, *Harry Potter*, or yoga. All told, Amazon rolls out 50 community features on its site every year. "We spend a lot of time looking at what customers are doing and seeing what they are saying," says Dicker.

Executives at Amazon currently are focused on increasing the relevance of customer-generated content through software enhancements. One effort is aimed at offering more localized information. So if you are shopping for a TV, a listing for nearby TV installation services might pop up. Another effort is geared to improving the relevance of consumer opinions. One example launched in September: a feature that highlights the ratings of specific product attributes. A review of a digital camera, for example, will now include ratings of key features such as battery life or picture quality. Click on the attribute, and it serves up all the reviews addressing that feature. "We want to make it more and more convenient for people to find the right products," says Dicker.

For Amazon.com, community is not just a way to tap into consumer desires. It also provides a competitive advantage. By amassing one of the world's largest collections of consumer opinions, the site has become a leading source of product reviews. And those reviews are a valuable magnet that lures more consumers to its Web site. "You increasingly look at Amazon for reviews," says Sebastian Thomas, head of U.S. Technology Research

at RCM Capital Management, an investment firm with a stake in the company. "It will be hard for someone else to build that scale."

Retail experts say one of the most profound changes in consumer behavior over the past few years is the emergence of such information-based shoppers. Typically, they are educated workers with broadband connections who are strapped for time and suspicious of TV ads. So they increasingly shop online. "The biggest change is the amount of research consumers are doing before they leave their houses," says Paul Ryder, Amazon.com vice-president of consumer electronics. The surge in online research was originally driven a few years ago by high gas prices. But Ryder says information shopping now has more to do with the convenience and value offered by the Web as frugal shoppers hunt for the best bargains. Another recent shift, Ryder says, is that consumers are doing more research for commodity products, such as cleaning solutions, instead of just big-ticket items such as a car or home.

A JOKE GOES VIRAL

One example of the power of online feedback popped up on Amazon.com in November 2008 when Brian Govern posted a satirical review of a T-shirt emblazoned with three wolves. "This item has wolves on it, which makes it intrinsically sweet and worth five stars by itself, but once I tried it on, that's when the magic happened," he wrote. "After checking to ensure that the shirt would properly cover my girth, I walked from my trailer to Wal-Mart with the shirt on and was immediately approached by women."

No one paid much attention to the review until it appeared on collegehumor.com on May 4, 2009. Then it went viral. To date, there are nearly 1,500 reviews on the Mountain Men's Three Wolf Moon Short Sleeve Tee, and more than 15,000 people have voted Govern's original review as "helpful." Although there were instances in the past where products received thousands of comical reviews, Amazon.com says this was the first time in which the jokes catapulted the item to best-seller status. For several weeks in June and July, the T-shirt was the No. 1 apparel item in the store. "The breadth and depth of reviews are very important to customers," says Ryder. "We are using them more than what salespeople or our friends tell us." | BW |



FACEBOOK BANKS ON A LITTLE HELP FROM ITS FRIENDS

By Douglas MacMillan

Mixing its social network with e-tailing adds a twist to online shopping—and a source of potential revenue

Merrill Squires avoids car salesmen at all costs. So when the 48-year-old marketing executive from Dallas was choosing between a Chevrolet Tahoe and a GMC Yukon Denali recently, he turned to his 600 Facebook friends. Dozens responded, and one old pal—a Denali owner—steered him toward the Tahoe. "I trust his opinion on it, and I would never have thought to pick up the phone and call him," Squires says.

Social-media networks are starting to influence all kinds of purchases, from cars to movie tickets. Shoppers sift through Twitter posts for opinions about gadgets or running shoes. They turn to Kaboodle, a Web site for sharing shopping lists, to get gift ideas. But Facebook, with 300 million users worldwide, has the best shot at combining retail and social media in bold and lucrative ways, and it's chipping away at this challenge.

Last year the company rolled out Facebook Connect. When retailers use this service, they get a Facebook log-in window on their Web site. That allows Facebook users to tap their friend lists for input as they shop. Already, 43% of online retailers have signed up, according to researcher e-Tailing Group, and an additional 31% plan to join in the next year.

Facebook Connect does add a twist to the experience of visiting an online store. When shoppers who are logged into Facebook see an item they want to buy, they can press a button, sending a photo and product details to the pages of their friends, who can give it the nod or recommend something else. These comments can pop up months later when mutual friends are looking for similar information. Brian Bateman, 33, uses Connect when he buys concert tickets from Live Nation to recruit friends to go with him.

MARC BURCKHARDT



Facebook's director of platform marketing, Ethan Beard, says the idea is to make e-commerce more like going to the mall with friends. Shopping can be a "social experience, but with the Web it turned into sitting by yourself [at] a monitor," says Beard. "Social media and tools like Facebook Connect are making shopping social again."

For five-year-old Facebook, retail may be the path to profits. Advertising currently makes up most of its estimated $500 million in revenues, but online ad growth is slowing. Investors foresee shoppers opting to use Facebook rather than search engines such as Google. "That's the vision. That's why Facebook is worth so much money," says Dave McClure, a consultant with Founders Fund, a venture capital firm that backed Facebook in 2006.

POWERFUL COMBINATION

For now, Facebook lacks an online payment method, but it recruited a handful of staffers, including at least one executive, from eBay's PayPal. A payment system would allow it to collect fees from merchants for transactions performed within the Facebook network—a potentially huge revenue source, based on how well retail and social media have been mixing. Fashion designer Diane von Fürstenberg has set up a promotional page on Facebook that has attracted 25,000 fans. And next month she plans to launch a line of sunglasses at the same time that her retail Web site begins offering Facebook Connect.

Others are skeptical that the social circles people develop on Facebook have the power to change the way we shop online. "I don't know that enough of us have [Facebook] networks large enough that there is overlap in what products we are looking for," says Sucharita Mulpuru, e-commerce analyst at Forrester Research. But many retailers are placing serious bets on friend power. T-shirt seller Threadless shows off a weekly roundup of new shirts to fans on Facebook, which is where it now spends the lion's share of its ad dollars. Says Cam Balzer, marketing vice-president for Threadless: "When you start to see the power of those audiences and the word of mouth ... it makes you want to get more out of that same audience." |BW|

RETAILERS ARE LEARNING TO LOVE SMARTPHONES

By Reena Jana

As apps have improved, m-commerce—buying all kinds of things via iPhone and BlackBerry—is rising

People are using their smartphones for more than just making calls, sending e-mails, or watching YouTube videos. The fastest-growing cellphone activity is shopping directly from a handset, reports market researcher Gartner. Retailers from Amazon to CVS to Sears have recently launched "m-commerce" sites or software applications that allow shoppers to browse and buy books, medicine, or even lawn mowers from their iPhones and BlackBerrys. "It's in-and-out, surgical-style shopping behavior" influenced by the recessionary need to focus on necessities, says Thomas Emmons, head of the mobile innovation group at Sears.

Some of the iPhone apps enable mobile shoppers to do even more. While strolling among the bookcases at a brick-and-mortar Barnes & Noble store, people can use the Apple smartphone to snap a photo of the latest Jim Collins management title, for example. Image-recognition software triggers an algorithm to recognize the product in a database. The software then pulls up user reviews from Barnesandnoble.com on the handset's screen almost instantly to help shoppers decide whether to buy or pass. "We've seen a huge uplift in reservations of books for purchase in physical stores, as well as buying, from the iPhone app since we launched it," says Douglas Gottlieb, the retail chain's vice-president for digital devices.

$544 million

Projected 2009 m-commerce sales in North America

Data: ABI Research

In the travel industry, companies are using m-commerce to target businesspeople who need to purchase plane tickets and book hotel rooms while in transit. In the first four months after Marriott International launched an m-commerce application for all smartphones, in August 2008, customers used it to spend $2 million even as overall travel expenditures slumped.

Why is m-commerce suddenly capturing the attention of retailers and consumers? "Shoppers now have the ability to buy on their phones easily as retailers are starting to get the design of iPhone and other applications right," says Gartner analyst Hung LeHong. Shop-by-phone consumers can pick up purchases in stores or have them shipped home or to a hotel without logging on to computers or interacting with salespeople.

M-commerce software specialists say business is surging. Jason Taylor, senior vice-president for mobile products at New York's Usablenet, which created m-commerce sites for Sears, Limited Brands, American Eagle Outfitters, and CVS, says it has signed three times more contracts in the past quarter than in previous periods. With more people buying smartphones—Gartner's latest worldwide sales data show a 12.7% increase in units sold in the first quarter of 2009 from a year earlier—the m-commerce market is likely to keep growing. |BW|

COMMENTARY

THE AMERICAN SHOPPER: DOWN BUT NOT OUT

By Lee Eisenberg

U.S. consumers have an abiding weakness for the new—which is why retail sales are inching back up

Three years ago, I took a stroll down Michigan Avenue—the Magnificent Mile, as it's known to Chicagoans and credit-card-wielding tourists. The sidewalks and shops were jammed. I wandered in and out of a few stores, not to buy, just to look. Shopping as entertainment, remember? At a department store, I eavesdropped as a hulking man—in flip-flops on a very cold afternoon—inquired about Tom Ford's new fragrance. He was "dying to check it out."

A few days later, I read about Tom Ford's impending launch: an *eau de parfum* assault Ford was calling "Private Blends." They included Tuscan Leather and Tobacco Vanille. Each would cost $450 for a 250-milliliter bottle—pricey, yes, but excusable if they indeed delivered "hope in a bottle," as Revlon founder Charles Revson famously put it. As for Ford's marketing campaign, it lived up to what we had come to expect back in the fat and happy years: sensual, surreal, pretentious. Tobacco Vanille "unfolds with creamy tonka bean, tobacco flower, vanilla and cocoa, and finishes with a dry fruit accord"—which led me to wonder if it went better with meat or fish.

A few months later, I visited Paco Underhill in New York. Underhill is a much admired "retail anthropologist," a consultant best known for two best-selling books, *Why We Buy: The Science of Shopping* and *Call of the Mall: The Geography of Shopping*. As intriguing as Underhill's insights on the relationship between store design and shopping behavior—e.g., a woman's innate fear of "butt brush" in too-narrow store aisles—they were not what I had come for.

I wanted to know what Underhill saw coming. He had been circling the globe for decades, observing consumers from Sheboygan to Shanghai. And what he was seeing, he told me, was not the Tom Ford world. "The picture we've gotten of how and what people buy has been grossly exaggerated," he said. "Take the kids in this office, some of whom have six-figure incomes. They can't afford this city. When my father bought his house, it cost roughly his annual salary. Today, it's different. Take monthly expenses. We have a mobile phone bill, an Internet bill, a cable bill. A significant part of the population worries about downward mobility, which is why the Dollar Stores of the world are winning."

The day he said that, the Dow was at 12,190 and would go 2,000 points higher. Then the economy took a giant markdown. Among the bankrupt retailers: Circuit City, Eddie Bauer, and Crabtree & Evelyn. Within weeks of Lehman Brothers' collapse, *Vogue* sent out a reporter to scout the "aisles and aisles of inexpensive finds" at big-box discounters. Women's fashion blogs recommended the "70/30" rule: Stock your closet with 70% tried-and-true items, meaning old, and 30% new—presumably from H&M or Target.

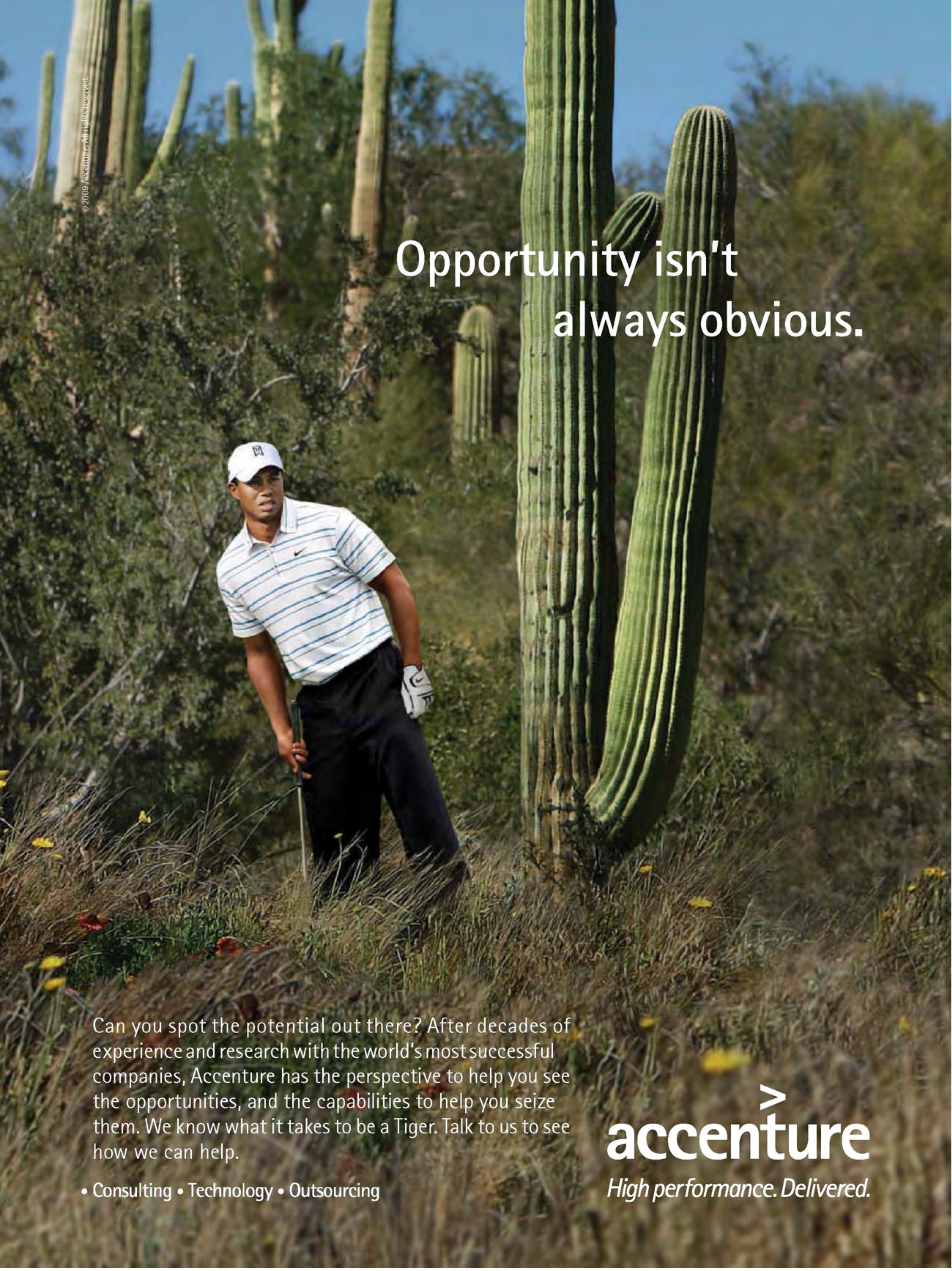
Which brings us to the $54—reduced from $64—question: Where does the U.S. consumer go from here? Having studied this fickle and put-upon species, I can offer the following: The American buyer has an abiding weakness for the new and the novel. If not Tobacco Vanille, then a pair of striped socks. We're nothing if not intrepid and resourceful. So while the American shopping cart is smaller than it was, and will remain so for a time, it's not surprising that there are now green shoots along the Magnificent Mile. Retail sales have been inching back up since August, and so has consumer confidence. Those pushing the carts are chastened—but don't count them out. Where there's a will to shop, there's a way. |BW|

Lee Eisenberg is the author of Shoptimism: Why the American Consumer Will Keep on Buying No Matter What, *in bookstores on Nov. 3.*



Eisenberg sees widespread "worries about downward mobility"

MATTHEW GILSON


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THE SPECTRE HAUNTING GE



By Jeff Gerth
Illustration by Paul Dallas

Many MRI patients are injected with a GE dye to enhance images. If they have weak kidneys, they might develop a rare and sometimes fatal disease

In May 2006 medical regulators in Denmark issued a warning that signaled trouble for General Electric. Danish researchers noted that, over a four-year period, 25 patients in Denmark and Austria had suffered a rare and crippling disease after undergoing an MRI, the scanning procedure used to diagnose everything from brain tumors to blown knees. The patients had been injected with a GE dye that makes images more distinct. They all had weak kidneys before receiving the dye. ¶ The GE product, Omniscan, has since been linked to other cases of the disease, which appears to affect only MRI patients who have kidney problems. Similar drugs made by Bayer and others have also been tied to the sometimes fatal ailment, nephrogenic systemic fibrosis (NSF).

Some regulators and researchers in the U.S. and Europe have found that a disproportionate number of NSF cases are associated with GE's Omniscan. That threatens to create a costly liability mess for the company's growing $17 billion health-care division, which GE promotes heavily with its "Healthymagination" ad campaign. The company's diagnostic products generate about $1.8 billion in sales. GE doesn't provide financial figures on Omniscan.

People with NSF, or relatives of those who have died, have filed more than 400 lawsuits in U.S. federal courts against GE, Bayer, and two other makers of similar drugs in the past several years. About 100 cases don't concern Omniscan. Of the roughly 300 that do involve the GE drug, about 70% relate exclusively to Omniscan, according to court records and lawyers on both sides. Bayer HealthCare has some 50% of the U.S. market, regulators estimate. GE is next, with about 30%.

While GE says it is investigating concerns about Omniscan, the company maintains there is no proof that the drug, known as a contrast agent, causes disease. "NSF is a complex disease with a number of contributing factors," GE said in a February 2009 position paper. It conceded that a critical ingredient in Omniscan and other agents may be one of those factors, "but not necessarily an essential [one]." Scientists concur that they don't fully understand how the disease starts, although nearly all cases have involved patients with kidney problems who were injected with MRI contrast agents.

The U.S. Food & Drug Administration has required since May 2007 that makers of contrast agents use a stern "black box" warning cautioning physicians to weigh carefully the benefits and risks for patients with weak kidneys. Screening



out people with kidney problems appears to eliminate the danger of NSF. But the FDA has not said GE's product is any more problematic than those of its competitors. The agency reached that conclusion even after two of its staff doctors—in findings disclosed here for the first time—determined that Omniscan is riskier than its rivals. GE had urged the FDA to treat all of the agents as equally risky.

Now one of the nation's leading imaging-safety experts, Dr. Emanuel Kanal, a professor at the University of Pittsburgh Medical Center, says that the FDA's decision to lump all contrast agents together is "inappropriate and indefensible." Kanal warns that the government's position potentially "endangers American citizens." The FDA, while defending its stance, says it will meet with Kanal to look at fresh data. (Kanal isn't working for any of the parties in the lawsuits.)

A spokesman for GE Healthcare, Ryan Fitzgerald, declined to comment specifically on the litigation or the FDA's position on contrast agents. GE is "confident in [its] legal positions," he added. On its corporate Web site, the company says Omniscan is superior to rival contrast agents because its "low viscosity" makes it easier to inject.

The companies that have been sued deny liability. In recent months, Bayer HealthCare has settled more than 100 cases related to its contrast agent, Magnevist, according to lawyers and court records. The terms have been kept confidential. Plaintiffs in the GE cases have not formally specified the total damages they are seeking. Their lawyers calculate a potential mass resolution could cost the conglomerate $1 billion. GE's executive director for corporate communications, Gary Sheffer, calls the $1 billion figure "a speculative and self-interested claim that is not supported by the facts."

THE ALLEGED CULPRIT

Some prominent physicians applaud the company's efforts to cooperate. Dr. Jeffrey C. Weinreb, a Yale School of Medicine professor of diagnostic radiology who has consulted with GE, says: "As far as I can tell, [the company] made a good-faith effort to provide relevant information" to medical professionals about Omniscan and the incidence of NSF. But Yale-New Haven Hospital, where Weinreb practices, has had several NSF patients die in recent years, he adds, and decided "to play it safe" and stop buying Omniscan in late 2006.

Omniscan and comparable products contain the potentially toxic metal gadolinium. During MRIs, the metal helps physicians see the brain and other parts of the body. Healthy kidneys filter out gadolinium. But patients with severely impaired kidneys can become victims of NSF, according to the FDA.

NSF starts with painful swelling in the legs and arms. It progresses to lesions in the skin and connective tissues, and it can attack organs, causing death. So far, there is no cure.

GE got into the contrast-agent business in 2004, when it acquired Amersham, a British maker of scanning drugs. About a week after the Danish Medicines Agency issued its international alert, GE Healthcare sent a letter to physicians acknowledging the Danish findings but stressing that the company was committed to keeping patients safe and informed. GE noted that Omniscan had been used 30 million times since its introduction in 1993. A "causal relation-



Imaging safety expert Kanal has concerns about the GE dye used with MRI scans

ship" between NSF and gadolinium-based contrast agents "has not been established," the company said.

By early 2007, however, regulators across Europe and in Japan were scrutinizing contrast agents. Omniscan appeared to be linked with more reported cases of NSF than its market share would have predicted, some regulators found. That March, the American College of Radiology, the professional group for doctors who administer imaging scans, issued guidance that Omniscan posed a greater risk than rival products.

The radiologists' warning contributed to decisions by several large hospitals in New York, Pennsylvania, and elsewhere to stop buying Omniscan. GE responded to the marketing challenge by making it easier for hospitals to receive financial incentives if they continued to purchase some Omniscan, according to court records and hospital executives.

DISSENT WITHIN THE FDA

In March 2007, GE published a position paper arguing that its diligence in encouraging reporting of NSF cases had created a "probable bias" in data showing the relatively large number of Omniscan-associated illnesses, compared with those involving competitors' products. The paper cast the NSF problem as possibly relating to the entire class of gadolinium agents. Omniscan and competing agents should be avoided, GE said, "unless the benefit clearly outweighs the risks."

The FDA, meanwhile, was receiving an increasing number of reports of NSF, records show. In 2007 two agency doctors raised concerns about Omniscan. The FDA assigned Dr. Melanie Blank, a kidney specialist, to review the safety of all contrast agents. Blank's report concluded that an "undeniable and strong association" existed between contrast agents containing gadolinium and NSF. She says in an interview she found that medical and sales data indicated Omniscan "had most of the cases and less of a share of the market, so I believed Omniscan was the worst player."

Another FDA staff member, Dr. Louis Marzella, did a separate review of Omniscan. In an Apr. 6, 2007, report, Marzella said "a contraindication for Omniscan is warranted" for patients with severe kidney disease. A contraindication has the effect of banning certain uses of a drug, regardless of the possible benefits.

GE repeatedly provided information on Omniscan to the FDA, as drug manufacturers routinely do. GE officials "knew we knew most of the cases were with them," Blank says.

In May 2007 the FDA ordered makers of all contrast agents to change their labels and highlight, in a prominent black box, the risks of NSF. The agency did not contraindicate the drugs for any patient. The FDA news release on the change listed Omniscan as the drug most often associated with NSF cases, followed by Bayer's Magnevist. The agency didn't provide actual numbers of cases.

R. Dwaine Rieves, as head of the FDA's imaging division, was ultimately responsible for the decision to issue an across-the-board warning. He says he was influenced by an Apr. 19 meeting at which senior FDA officials questioned the adequacy of data associating NSF with Omniscan. "What entered into our decision," he says, "was a very limited database."

After the FDA issued its blanket warning, GE reinstated requirements that customers purchase certain minimum amounts of Omniscan in order to receive financial incentives, according to Kathryn E. Goldstein, a spokeswoman for Novation, a purchasing organization for 25,000 health-care providers. Kanal, the Pittsburgh medical professor, says he confronted GE managers over what he considered their "inappropriate" decision to induce customers to buy Omniscan. Fitzgerald, the GE spokesman, confirmed the switch in financial incentives but declined to address Kanal's criticism.

Kanal, who heads a blue-ribbon panel on magnetic resonance safety for the American College of Radiology, says he is pressing the FDA to analyze a public database created by plaintiffs and manufacturers in the NSF litigation, among other new information. The FDA's Rieves has agreed to meet with Kanal on Oct. 20 and says he is receptive to new data: "We want to see it." |BW|

Editor's Note: Gerth is a reporter with ProPublica, a nonprofit journalism organization in New York. For more on GE and MRI drugs, go to http://www.propublica.org.

HEALTHY BUSINESS

In May, GE launched the "Healthymagination" campaign to promote its growing medical division. Some vital statistics:

SALES	PROFIT	PRODUCTS	EMPLOYEES	FINANCING
$17.4 billion	$2.85 billion	Imaging machines and related diagnostic products, monitoring devices, and medical records technology	46 thousand	GE Capital lends to many GE Healthcare customers

MICHAEL NEMETH/WONDERFUL MACHINE

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MANAGEMENT & LEADERSHIP

Putting Ford on Fast-Forward

To outrun rivals, company engineers revamped the development process for a new pickup engine

By David Kiley

Adam Gryglak had what seemed like an impossible task: deliver an all-new Ford diesel engine in 36 months. Ford was way behind schedule, so the time frame was a year faster than usual. Gryglak, the chief diesel engineer, knew he'd never meet his deadline without short-circuiting the usual development process. So he put together a team, moved off campus, and kept his second-guessing bosses at bay. Gryglak called the project Scorpion (after the heavy metal band the Scorpions) and came up with a logo featuring a menacing mechanical insect.

In mid-September, on schedule and to strong reviews, Ford unveiled the new Super Duty pickup—powered by Project Scorpion's engine—at the Texas State Fair. Gryglak had shown that the classic skunkworks model pioneered by Lockheed-Martin in the 1930s could help Ford protect its flank, in this case the highly lucrative market for contractor-grade pickup trucks. "We have a good product-development system," Gryglak says. "The key was to respect what we have and the people who run it, deconstruct it a bit, and make it better to suit our target."

Gryglak's task was doubly difficult. For one thing, Ford had previously outsourced the design and manufacture of the engine, known as the Powerstroke, to truck and engine maker Navistar. What's more, the Powerstroke brand



had eroded in recent years because of quality problems. Gryglak didn't just need to design and build an engine in-house from scratch—he needed to vastly improve it if Ford were to keep dominating the market for large pickups, which in good years have generated much of its overall profit.

Like all big companies, Ford has a strict product-development hierarchy. It works well enough nowadays that the carmaker can get new models from blueprint to showroom as fast or faster than its rivals. Going offsite inevitably made executives anxious. But Gryglak's pitch got a better reception than it might have, say, five years ago, when turf-obsessed managers tended to look unkindly on heterodoxy.

In October 2006, Gryglak began recruiting his team of engineers. He discovered that not everyone was eager to work beyond the bounds of Ford's familiar environment. Some engineers craved structure. "We had people self-select out because they weren't comfortable working outside their comfort zone," says Gryglak. But others couldn't wait to be asked. Ken Pumford, an engineer from Ford's Kentucky truck plant, moved from Louisville to Dearborn, Mich., to join the project.

It wasn't long before the benefits began to emerge. Specialists used to working only with their own kind became more familiar with what other engineers were up to. "We saved months by knowing hourly what the other guys were thinking and what their problems were," says Pat Morgan, a veteran Ford engineer. "The result was that the engine fit into the truck perfectly the first time, and that almost never happens."

The team's Scorpion mascot, named for the heavy metal band

The team also let go of certain Fordisms. The company has long forced suppliers to adapt their technology in hundreds of time-consuming ways to Ford specifications. Engineers, after all, justify their paychecks by coming up with engineering tweaks. With time short, the team learned to trust



Gryglak: His bosses forced themselves to stay in the background

(TOP) ROY RITCHIE/WONDERFUL MACHINE

suppliers more. For example, Ford let the German company Bosch work on the engine's antipollution device with minimal reengineering for its own sake.

FUN AND GAMES

Freed from the rigid atmosphere of Ford's tech center, the engineers let themselves have fun. They played jokes on each other, building full-size snowmen, decorated with machine parts, on one another's desks. Gryglak also encouraged friendly competition. In August 2007, after months of R&D but before starting to build the engine, the team organized a Pinewood Derby competition. Design and mechanical engineers, of course, weren't about to whittle cars from wood the way Cub Scouts do. They milled cars out of aluminum. Some had remote controls and electric motors.

As the team worked in isolation, Gryglak's bosses had a hard time staying in the background. Bob Fascetti, Ford's chief engineer of big engines, forced himself to check in with the team only every four to six weeks instead of the usual weekly or biweekly intervals. "It was tough for me to do," he says. "But to keep [the project] on track, I convinced my bosses it would be better to leave them alone." Fascetti says things got tense when Team Scorpion decided to build the engine out of a lighter material that would make the truck more fuel-efficient. Doing so was more expensive, with a greater risk of failure. By the time Fascetti and his own bosses found out, the decision had been made. Gryglak faced some tough questioning, but he got the green light.

The new Super Duty truck goes on sale in the spring. Ford says the engine will be the first of its kind to use state-of-the art antipollution technology that meets new federal regulations. The truck also will have the best fuel economy in its category and won't need significant maintenance for 300,000 miles. The best part, says Tony Hudson, a Project Scorpion engineer, is that the team pulled off what initially had seemed impossible. "That," he says, "will give us license to do it again." |BW|

Business Exchange

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Busting Bureaucracy

In his 1990 book *Adhocracy: The Power to Change*, Robert H. Waterman defined "adhocracy" as "any organization form that challenges the bureaucracy in order to embrace the new. It cuts through organizational charts, departments, functions, job descriptions, hierarchy, and tradition like a hot knife through butter."

To read an excerpt from the book, go to **http://bx.businessweek.com/change-management/reference/**

Timken Plots a Rust Belt Resurgence

The Ohio maker of specialty steel has 60 PhDs developing new alloys to tackle punishing conditions

By Stephen Baker

You might look at Timken, the Canton (Ohio) manufacturer of bearings and specialty steel, and wonder if pursuing a diversification strategy is worth the bother. In the last six years the $5.7 billion Timken has branched into new businesses while lowering its sales to the auto industry from 40% of revenue to less than 20%. Yet even while skirting much of the fallout from the automakers' woes, the 110-year-old company keeps getting hammered. "I never dreamed we'd see a recession where demand for our products fell by 40% to 50%," says CEO James W. Griffith.

Still, by shifting its focus away from nearby Detroit, Timken is plotting a path for Rust Belt resurrection. The strategy, which includes a total of $3 billion in sales and acquisitions to date, points Timken toward high-margin niche markets, many of them overseas. The key is to find places for its highly engineered parts in far more expensive and demanding machines than Chevys or Fords. Timken figures customers will pay for premium parts in industries in which breakdowns can spell disaster. Aerospace, which accounted for $400 million in Timken's sales in 2008, is a priority. Says Douglas H. Smith, senior vice-president for technology: "We want to go where the cost of failure is very high."

That's the thinking that led Timken to windmills. As windmills get bigger, the demand to place precise and dependable components inside them will grow. "Think of it," says Griffith. "You've got turbines the size and weight of a school bus" spinning on poles hundreds of feet in the air. He predicts that windmill components, which now account for less than $50 million in sales, "will be the fastest-growing part of Timken over the next two or three years."



Griffith and Smith in front of a wall listing Timken's U.S. patents in Canton, Ohio

MICHAEL NEMETH/WONDERFUL MACHINE

COMPETING ON QUALITY

The company is putting finishing touches on a plant near Shanghai to serve China's booming windmill market. Timken's main competitor for these large industrial parts, says Eli Lustgarten, senior vice-president at Longbow Securities, is another premium player, Sweden's SKF Group. The two, he says, are more likely to battle over service and quality than wage costly price wars. That bodes well for Timken's bottom line.

To keep ahead of the commodity players, Timken is banking on its 300-member research and development team, which includes 60 PhDs. The scientists are developing exotic alloys that can withstand punishing conditions. In offshore drilling, for example, a single pipe must burrow seven miles into the earth. If the detonations necessary to break open pockets of oil and gas deform a pipe, Smith explains, the hole is ruined, and the damaged pipe turns from a conduit into a plug.

The company expects the recovery in its markets, whenever it comes, to be rapid. When the recession hit last fall, Griffith's customers cut orders at record speed. He attributes their quick response to the latest generation of enterprise software, which provides a fast and precise read on sales, production, and industrial supply chains.

Griffith thinks orders will return just as quickly. So while he reduced Timken's labor force in the last year by 20%, cutting 5,000 jobs, he is readying his plants to gear up. The 25% of office jobs he cut are gone for good. The goal, he says, is for Timken to emerge from the recession nimbler and more global than it was at the start. |BW|



CEO Young at HQ: An apple juice with 40% less sugar has been a hit

NANCY NEWBERRY

STRATEGY & COMPETITION

Why Dr Pepper Is in The Pink of Health

Freed from Cadbury in 2008, it has been cutting costs while building up brands and sales

By Nanette Byrnes

In the soda wars, Dr Pepper Snapple Group (DPSG) has long run a distant third to Coca-Cola and PepsiCo. But the beverage maker is experiencing a surprising renaissance. Its stock is up 154% since March, compared with a 33% climb for Coke and a 32% rise for Pepsi. Sales of its flagship brand, Dr Pepper, are bucking the industry trend, rising almost 3% in the first half of this year while overall soda consumption dropped by that much, according to *Beverage Digest*. Analysts expect the company to post a $498 million profit this year, up from a $312 million loss in 2008.

For CEO Larry D. Young, the turning point in DPSG's fortunes came with the Plano (Tex.) company's spin-off from Cadbury in May 2008. That allowed Young to cut costs and invest the savings in building up long-neglected brands and distribution networks. His team no longer has to wait months for decisions to be vetted by the U.K. parent or kick up profits when London management came "dialing for dollars," as Young puts it. (Cadbury declined to comment.) Now he's focused on bringing more attention to his 58 brands, which include A&W Root Beer, 7Up, and Canada Dry, along with Dr Pepper and Snapple.

"THEY HAVE TO BE SCRAPPY"

That means more money for quirkier and more plentiful advertising, a push for new products, and wider distribution. Much of the company's efforts are focused on the austere, all-white laboratory housed on the first floor of headquarters. Here a team of 75 food scientists, chemists, microbiologists, and engineers team up to create the next generation of DPSG products. Their $17 million budget comes nowhere near PepsiCo's $388 million for research and development, but it has had an impact, with seven new products launched last year. When research showed that parents were watering down their children's juice to cut back on calories, the team created a new version of its Mott's apple juice with 40% less sugar but the nutrition of full-force juice, called Mott's for Tots. That hit a note with moms worried about empty calories, prompting Young to add new flavors and product sizes.

DPSG is also working more closely with retail partners like 7-Eleven. Young moved the research team from Connecticut to Texas partly to integrate customer feedback better. "They're aggressive, and they understand that they have to be scrappy," says 7-Eleven CEO Joseph DePinto. Another hit: Canada Dry Green Tea Ginger Ale, which boosted volume 2.6% in the ho-hum category of soda. Though Snapple sales continue to sink despite resizing the bottles to fit into a car's cupholder, a switch to sugar from corn syrup, and new advertising, Young is determined to reverse that trend: "If it's going to be in my company's name, by God, we're going to do something with it."

He has upped his marketing budget while rivals have cut back. Eric Hirshberg, president and chief creative officer at Deutsch LA, DPSG's advertising firm, argues that "Coke and Pepsi, all they have to do is remind you why you like the brand. Dr Pepper has to tell you why you should drink this more."

But the biggest key to success is distribution. Recently Dr Pepper scored a coup: a fountain spigot in McDonald's 14,000 U.S. restaurants. And staffers like Tony English, DPSG's director of supermarket sales in Dallas-Fort Worth, where people drink more Dr Pepper than Coke, spend their days hustling from one store to the next. His team's only day off: Christmas. Young would have it no other way. "Strategy is fantastic," he says. "But execution is what brings the results in." |BW|

Blasting Away at Product Placement

Critics consider the practice stealth advertising—and are pressuring the FCC for tougher regulation



DANIEL HERTZBERG

8%

Growth in prime-time TV product placement in first half of 2009. Number of placements: 9,540.

Data: Nielsen

By Tom Lowry and Burt Helm

Nothing infuriates Corie Wright more than when a TV network and advertiser try to sneak a product pitch past viewers. Case in point: Elisa and Jack of *30 Rock* fame discussing whether McDonald's McFlurry is the best dessert in the world. "It's egregious and deceptive," says Wright, a lawyer and policy adviser for Free Press, a nonprofit activist group. "Product placements don't allow us to have the usual veil of skepticism we have when we watch a standard commercial."

Free Press is among a coalition of 50 groups waging war on product placements. The critics, who range from consumer advocates to pediatricians seeking to protect kids from sugary cereal, are calling on the Federal Communications Commission to implement tougher disclosure rules for what many activists consider stealth advertising.

Product placements are nearly as old as TV itself, but they have become ubiquitous in recent years—especially as recession-hit advertisers scramble for a cost-effective way to reach consumers. In the first half of this year, product placements in prime time rose 8% from the same period in 2008, says ratings tracker Nielsen. Fox's *American Idol* alone had 580 product placements.

Other than rules that restrict how much advertising networks can put in kids' programming in a given hour, the FCC has few regs for product placements. Last year the commission, under pressure from Congress, asked for comments from the public on how it might regulate placements, but little has been done since. A spokeswoman for FCC Chairman Julius Genachowski says his first priority is implementing a national broadband policy and that product placement is on the "back burner for now."

RED LIGHTS ON SCREENS?

That is not deterring protesters, who are meticulously tracking product placements as the fall TV season gets under way. They are troubled not just by products that appear in shows but also by so-called integrations, when products are actually written into plotlines. On CBS's *The Big Bang Theory*, for example, Sheldon informs Penny that he needs access to the Cheesecake Factory's walk-in freezer.

Critics want the FCC to require networks to disclose placements. Their proposals range from forcing programmers to run text along the bottom of the screen when a product appears in a given scene to a flashing red light on the screen alerting viewers that an advertiser is pushing something. None of this sits well with TV programmers. "Seriously, what viewer is going to stand for that?" says a network executive, who, like many of his peers, was loath to speak on the record.

Advertisers aren't thrilled, either. Tony Pace, Subway's chief marketing officer, opposes disclosures, except at the end of a program. In shows such as *Chuck* and *The Biggest Loser*, Subway staffers collaborate with the producers to work the brand into the plot. In one *Biggest Loser* episode, the dieting contestants hiked from one Subway to another to get a meal as part of the contest rules. "We'd rather seem like a natural part of the show," says Pace, "rather than punch the viewer in the nose with a message like, 'Hey, this is paid for.' "

Clearly, the FCC's Genachowski faces a delicate balancing act: protecting the public on the one hand without undermining the already precarious economics of television. |BW|



Lee: He'll make more cuts if needed to get Bobcat back in the black

JAE-HYUN KIM

STRATEGY & COMPETITION

Korea's Biggest Foreign Deal Ever Bites Back

The $4.9 billion buy of Bobcat by Doosan is proving to be an embarrassing drag on the powerful *chaebol*

By Moon Ihlwan and Jena McGregor



SEOUL

Doosan is one of the largest *chaebol*, or conglomerates, in South Korea, with some $20 billion in sales. A maker of construction equipment and builder of industrial plants, Doosan is not nearly as well-known globally as Samsung, LG, or Hyundai Motor. But in Korea it's seen as the *chaebol* that pulled off the biggest foreign takeover ever. And that, it turns out, has proven to be a problem.

Doosan's $4.9 billion acquisition in 2007 of Bobcat, a North Dakota maker of compact earth movers, was modest by U.S. standards. But it was a seminal moment for Korea Inc., which had largely avoided acquisitions abroad until Doosan outbid others for Bobcat and two related businesses, which all belonged to Ingersoll-Rand.

But today, Doosan Infracore, the unit that controls Bobcat, is reeling. The economic crisis has halved Bobcat's revenues and pushed Doosan Infracore into a loss of $46 million for the first six months of 2009. "The timing [of the takeover] was bad," concedes Lee Sang Hoon, Doosan's chief strategist. "But no one could have thought the worst recession in 70 years was in store."

Scott R. Nelson, who runs Bobcat and the other acquired businesses for Doosan, will have slashed staff 40%. He says the Koreans will not cut and run. "Our chairman [Doosan's Y.M. Park] has a very long-term view. He doesn't look at this as a one-, two-, or three-year payback," he says.

That's good, because it will take a while to sort out the finances of the deal. The Koreans relied on bank loans and outside investors for 86% of the acquisition cost. To secure good terms from its banks, Doosan agreed to repay loans early if Bobcat's cash flow fell below normal levels. Now that the business has drastically shrunk, Doosan this year has to pay back $600 million of the $2.9 billion Bobcat borrowed to pay for its own acquisition.

Doosan's equity partners in the purchase also got special terms to back the deal. The partners planned eventually to take their share of Bobcat public. If that proved unlikely, they could sell their investment back to the Korean parent with a guaranteed return of 9% compound interest. A public offering of Bobcat seems impossible anytime soon, so Doosan will probably have to pay $1.23 billion by 2012 to its equity investors.

Former executives grumble that the Koreans mishandled the acquisition. One veteran, who declined to be named, says Doosan, spurred on by rival bids and its own ambitions, overpaid. "It was national pride," he says. (An industry consultant figures the Koreans spent $1 billion too much.) The ex-manager also cites differences in management culture: "They wanted everything controlled out of Korea."

Nelson disputes that there has been a culture clash. "There's no question that Asian culture is different from American culture," he says. "But I wouldn't call it a clash at all. It's a learning curve." He adds that Bobcat has gained market share in its key products since the Koreans arrived.

Clash or no, Doosan has no choice but to struggle on. Little growth is expected for the U.S. construction equipment business until 2011. Strategist Lee pledges more cuts if necessary to get Bobcat back in the black.

And the reaction in Korea to Doosan's difficulties? Korean executives don't say publicly that Doosan made a wrong move. But in a recent survey of 37 major companies, all but two said they have no plans to seek acquisitions. |BW|

-59%

Sales decline for Bobcat and other Doosan operations in the U.S. in the first six months of this year

Data: Doosan Infracore

A Hiring Hitch For Small Business

Wary of being burned, temp agencies are making it much more difficult to employ workers

By Jeremy Quittner

SMALL BIZ

Virtual Computer, based in Westford, Mass., was ready to go. After securing $21 million in venture backing, it was time to ramp up from 6 employees to 40. That meant Doug Lane, senior director of product management and marketing, needed to hire software engineers, administrative assistants, and sales and marketing pros. So he turned to regional staffing agencies for help.

Lane had expected to sign on a dotted line and have his workers show up soon after. But that's no longer the way temp agencies work with small companies. Instead, the agencies wanted to meet with Virtual's management team, and with their venture backers, for added assurance that the $1 million company had the funding it claimed.

Even as economists and policymakers are counting on small companies to help lead the economy out of the recession, business owners seeking temporary workers as the first step in hiring are finding agencies less willing to do business with them. Temporary agencies, afraid of getting burned by companies that are going under, are scrutinizing potential customers more carefully, checking financial documents and credit reports. And they're expecting small business owners to pay up sooner—often within seven days. The result is predictable: "It starts to slow the business down," says Michael Gaiss, senior vice-president of Lexington (Mass.) venture capital firm Highland Capital Partners.

Until recently, small businesses could more easily get credit from a temp agency than from a bank, says Bill Kasko, CEO of Frontline Source Group, a Dallas staffing company. "You could call an agency and say, 'I need to hire three individuals,' " says Kasko. "You would probably get an agreement, and they would not want to do a credit check." The agency pays workers immediately, even though the agency itself might not get paid for a month or more.

WHEN CHECKS ARE LATE

Kasko says all new clients now get site visits. He keeps an eye out for red flags, such as a request for extended payment terms or an unwillingness to sign an agreement. He'll also check to see if the company has made layoffs recently, and he's quicker to pull workers if payment doesn't arrive on time. Still, he has had to file 10 lawsuits for nonpayment this year, totaling $200,000. Kasko says nearly 75% of his new business is from companies with fewer than 100 employees. Before the recession, small businesses accounted for less than 50%.

At Bayside Solutions, a temp agency in Pleasanton, Calif., "We are definitely conscious of a company's creditworthiness," says President Ed Williams. Entrepreneurs used to get 30 days to pay; now they get seven. He scrutinizes a company's credit report, and new clients may get approved for fewer employees than they might have during flush times.

For some agencies, even those tactics don't provide much reassurance. "We rarely work with brand new businesses," says Suzanne G. Davis, president and owner of Temporary Staffing by Suzanne, a small recruiter in New York, echoing many in her industry. That can leave a wide range of entrepreneurs ramping up more slowly than they'd like—unless, like Virtual Computer, they have $21 million in the bank. |BW|

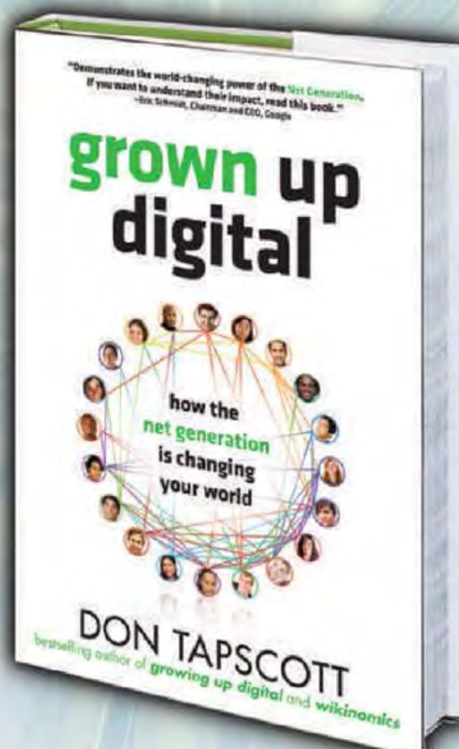


ROBERT NEUBECKER

"A MUST READ...if you understand the Net Generation, you will understand the future."

—The New York Times

"FASCINATING.
An insightful, data-rich analysis with broad implications for managers, marketers, and politicians."
—BusinessWeek



"Demonstrates the WORLD-CHANGING POWER of the Net Generation."
—Eric Schmidt
Chairman & CEO, Google

"AN OPTIMISTIC VIEW of how humans are evolving to engage with technology."
—The Wall Street Journal

"*Grown Up Digital* is an ESSENTIAL READ."
—William D. Green
Chairman & CEO, Accenture

"A portrait of this generation that is ENTERTAINING, OPTIMISTIC AND CONVINCING."
—The Economist

"A THOUGHTFUL ANTITHESIS to entrenched and sometimes alarmist managerial opposition to internet-influenced behaviours."
—The Financial Times

"No one has been A MORE INFORMED COMMENTATOR on the transformative impact of the digital age than Don Tapscott."
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THE BENEFITS OF CLOUD COMPUTING



THE LATE-1800S transition from private electric generators to centralized, utility-based power production was one of the most important events in U.S. industrial history.

Freed of the need to invest in expensive electric generators, companies could secure the electric power they required, as well as instantaneously scale their power usage to meet unexpected or seasonal demands, through a simple power-line hookup to the local utility. Commercial operations that once were the province only of the well-heeled or well-planned suddenly became available to anyone with a good business idea and the means to put it into practice.

The same revolution is taking place today, more than a century later, in enterprise computing. For decades, IT-dependent companies have had no choice but to invest in ultra-pricey mainframes and, later, enterprise-class servers in order to store their data and manage their applications. In so doing, they often have found themselves investing many years and millions of dollars in IT infrastructures that, while operationally essential, usually do little to distinguish their products or services in the marketplace or strengthen their competitive position. It's simply a "cost of doing business."

THE EMERGENCE OF CLOUD COMPUTING

Well, those cost equations are just about to change. Enter "cloud computing"—a computing model that promises to do for enterprise computing what centralized power generation did for the growing industrial economy of the late 1800s. With cloud computing, companies no longer need to build expensive, high-maintenance, internal IT networks before they can have access to the computing power and network integration their operations require. They merely "plug into" a distributed, virtual network of computing, storage, and security resources—reducing their IT costs sometimes to a fraction of their former levels.

But cost savings are only one of the benefits of cloud computing. The flexibility and scalability inherent in cloud computing are also unprecedented. Enterprises can outsource either all or any part of their IT infrastructures, and they can make these decisions on a department-by-department basis without having to impose rigid, enterprise-wide standards. Moreover, companies can instantly have access to spike capacity and seasonally based surge resources without having to waste money on fallow capacity the rest of the year. And the best part: they can do it all without increasing budget-constrained headcount or capital expenditures.

SECURITY IN THE CLOUD

Companies like Amazon, Dell, Google, HP, Microsoft, and Sun have become leaders in the use of cloud computing because they recognize its cost and flexibility advantages. But cloud computing is not without concerns—security being chief among them. Indeed, in early incarnations, cloud computing architects faced severe challenges in trying to erect a robust security architecture for an IT network based on virtual machines, rapidly shifting deployment patterns, and Internet-based access. Legitimate questions were raised about matters ranging from intrusion detection and prevention to data integrity and protection.

Fortunately, advances over the succeeding years have made it possible to put these concerns to rest. Innovations like Trend Micro's "security in the cloud" offerings have made cloud-computing environments just as secure as internal IT networks or site-based data centers, if not more so. Trend Micro's cloud-based Smart Protection Network™ leverages intelligence gained over millions of nodes, and can instantaneously and continuously deploy new signatures, heuristics, and antivirus and anti-malware patches throughout the cloud—a level of real-time security that no location-based IT network can match. Moreover, once one client's data or applications are protected against a new threat, the data and applications for *every client* in the cloud is protected at the same time. And small, mobile devices, like cell phones and PDAs, that lack large memory stores nevertheless can receive the same degree of protection as multi-CPU servers.

Clearly, the maturing advantages of cloud-based computing are worth exploring, especially for companies struggling to balance growing computing and security needs with shrinking IT budgets. If you're among them, perhaps it's time you took a look.

For more information on Trend Micro's cloud computing security solutions, visit **WWW.SMARTPROTECTIONNETWORK.COM**


North America and Europe deployed more virtual than physical servers in 2008.
95% of data centers are deploying virtualization
TECHNOLOGY
Gartner VP Neil MacDonald: Virtualization will be the target of new security threats**
88% of North American companies don't have a virtualization security strategy
60% OF PRODUCTION VIRTUAL MACHINES ARE LESS SECURE THAN THEIR PHYSICAL COUNTERPARTS.*
THINK CONVENTIONAL SECURITY CAN PROTECT YOUR VIRTUAL ENVIRONMENT?
THINK AGAIN.
Enterprises around the world are relying on virtualization to increase data center efficiency and, unknowingly, leaving themselves more vulnerable. That's because conventional security isn't able to protect virtual machines or see the traffic between them – leaving data and networks exposed. Which is why, according to Gartner Group, in 2009 sixty percent of virtual machines are less secure than their physical counterparts. But with Trend Micro™ Enterprise Security, powered by the Trend Micro™ Smart Protection Network™ infrastructure, you can mitigate the risk and maximize the benefits of virtualization. It's a different kind of security that protects your physical and virtualized environments and helps set the foundation for your company to move confidently into the cloud.
▸ Learn how to protect your virtualized data center. Download the Trend Micro eBook at trendmicro.com/thinkagain
TREND MICRO™
Securing Your Web World
© 2009 Trend Micro Inc. All rights reserved. Trend Micro and the t-ball logo are trademarks or registered trademarks of Trend Micro Inc. All other company and/or product names may be trademarks or registered trademarks of their owners. *Per Gartner Group Vice President Neil MacDonald, as quoted in: McLaughlin, Laurianne; "How to Find and Fix 10 Real Security Threats on Your Virtual Servers," CIO Magazine, 14 November 2007, www.cio.com/article/print/154950 **Per Gartner Group Vice President Neil MacDonald, as quoted in: "Gartner: Rush to Virtualization Can Weaken Security," On-Demand Enterprise, 09 April 2007, http://www.on-demandenterprise.com/offthewire/gartner_rush_to_virtualization_can_weaken_security_07-29-2008_08_52_18.html

YOU USE YOUR CITATION TO BUILD BUSINESS. NOW USE IT TO BUILD ESTEEM.



CITATION SPECIAL OLYMPICS AIRLIFT

Next summer a fleet of Cessna Citations will transport some 2,000 athletes to and from the 2010 Special Olympics USA National Games in Lincoln, Nebraska, in what will be the largest civilian airlift in history. But it can't happen without your help. We need your Citations, and your pilots, to complete this historic mission. If you are the owner or operator of a Cessna Citation, please participate in the 2010 Citation Special Olympics Airlift. It promises to be an experience that will change your life as much as the athletes who board your aircraft.

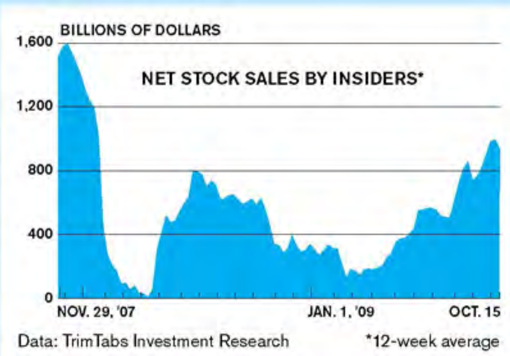
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068 How to Play It: The falling dollar
069 Investing: Looking past earnings
070 Inside Wall Street

MONEY REPORT

INSIDER SELL-OFFS



Data: TrimTabs Investment Research *12-week average

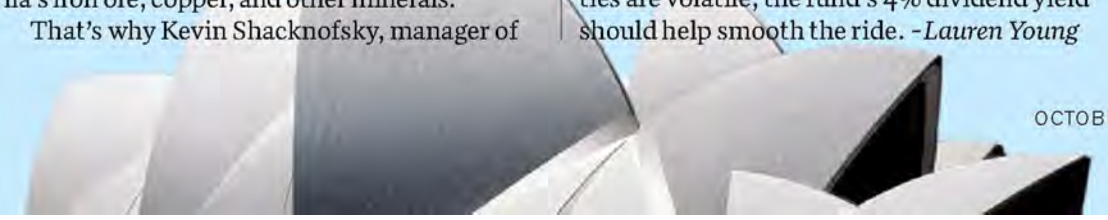
The Dow broke 10,000 on Oct. 14, but insiders have been signaling a stock market pullback. Since Sept. 1 directors and executives at publicly traded U.S. companies have sold $40 worth of shares for every $1 of purchases. That compares with $22 in sales for every $1 buy from March through August. Insider selling hasn't been this high since the downturn began at the end of 2007, according to TrimTabs Investment Research. "We've never seen a market bottom when there weren't significant levels of insider buys, and we've never seen a top without significant selling," says TrimTabs CEO Charles Biderman. ¶ Activity by S&P 500 executives was particularly pessimistic in the third quarter, notes InsiderScore, as insiders sold almost $63 in stock for every $1 purchased. CEOs of all public companies unloaded $1.7 billion in company stock vs. about $95 million acquired, including Cisco Systems CEO John Chambers' $9 million sale in August. InsiderScore data also show that sentiment is especially negative at industrial goods, service, and technology companies. *–Tara Kalwarski*

STOCKS

BANKING ON AUSTRALIA

While the rest of the Group of Twenty countries may be stuck in a slump, the economy is perking up Down Under. Australia's central bank unexpectedly raised its short-term interest rate target by a quarter-point on Oct. 6, to 3.25%, after economic data showed the risk of "serious economic contraction" had passed. The Australian dollar also hit a 14-month high against the U.S. dollar. Australia's economy is puny compared with those of its G-20 brethren, but it has close ties to Asia—China is a key consumer of Australia's iron ore, copper, and other minerals.

That's why Kevin Shacknofsky, manager of the $600 million Alpine Dynamic Dividend Fund, owns the stocks of Australian commodities producers such as iron ore powerhouses BHP Billiton and Rio Tinto. "Australia also has one of the world's strongest financial systems," he adds, noting its limited exposure to subprime debt. Shacknofsky likes National Australia Bank and Westpac Banking Corp. One way for investors to play commodities as well as Australian banks is the iShares MSCI Australia Index exchange-traded fund, which has a 38% stake in financials and 35% in commodities producers like Rio Tinto. Although commodities are volatile, the fund's 4% dividend yield should help smooth the ride. *-Lauren Young*


Sydney: Attracting investors and tourists

(BOTTOM) ANNE RIPPY/GETTY IMAGES



OIL

STRATEGIC SPENDING

ConocoPhillips unveiled a new strategy on Oct. 7 aimed at improving shareholder returns, including an increased dividend payout and plans to reduce debt. Since then, the stock is up 5%, to 50.97.

The $75 billion energy company said that over the next two years it intends to unload $10 billion in assets that require a lot of cash to maintain. It also plans to reduce spending on machinery and other capital equipment in 2010. It will pay shareholders a 50¢ quarterly dividend Dec. 1. At 4%, its dividend yield is "the most generous" among U.S. oil and gas companies, notes independent research firm Collins Stewart, which expects shares to hit 60 by yearend 2010. This outlook is based on relatively strong crude oil prices: Collins Stewart thinks prices will average out to $80 per barrel in the long run. In the third quarter, crude oil averaged $68 per barrel. *–T.K.*

WHAT HAPPENS IF THE DOLLAR CRASHES

(FROM PAGE 018)

By Tara Kalwarski

The dollar is in its eighth straight month of decline against other major currencies. An easy way to hedge a portfolio against continued and possibly deep losses is to increase your exposure to international companies less affected by a volatile U.S. currency. Since 1970 a global portfolio has outperformed the Standard & Poor's 500-stock index.

GOING GLOBAL PAYS



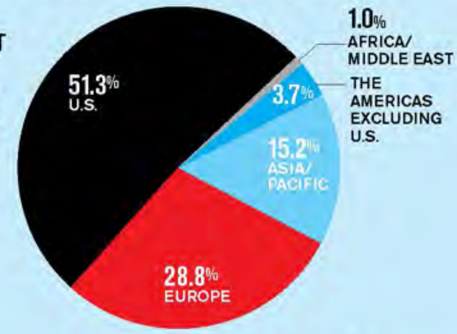
Data: Ibbotson Associates *Equally weighted mix of U.S., European, and Asia/Pacific stocks

A SMALLER U.S. SLICE

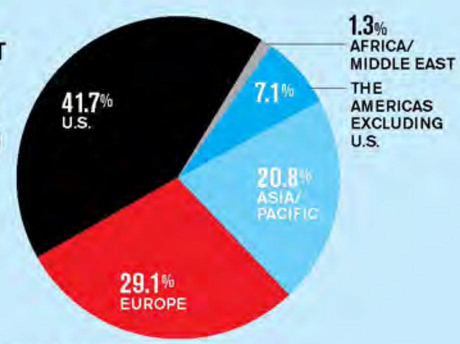
Overseas stocks now account for a larger share of the world market, with U.S. equities dropping by almost 10 percentage points over the past five years. Consider changing your international exposure to mimic the global mix.

BREAKDOWN OF THE MSCI ALL COUNTRY WORLD INDEX*

2004 MARKET CAP: $19.5 TRILLION



2009 MARKET CAP: $24.0 TRILLION



*As of Oct. 8 in U.S. dollars

BUSINESSWEEK.COM | To comment on How To Play It stories and see the related video interviews, go to businessweek.com/go/09/playit

DIVERSIFYING OVERSEAS

Investing in foreign equities used to be a pricey proposition for retail investors. These mutual funds come highly rated by Morningstar and offer a range of geographic mixes.

FUND/TICKER	EXPENSE RATIO	TOTAL RETURN*: ONE YEAR	TOTAL RETURN*: FIVE YEAR	GEOGRAPHIC BREAKDOWN: AFRICA/ MIDDLE EAST	ASIA/ PACIFIC	EUROPE	LATIN AMERICA	NORTH AMERICA
Janus Overseas/JAOSX	0.89%	67%	19%	0.6%	47.7%	13.4%	12.0%	26.4%
Vanguard Total International Stock Index/ VGTSX	0.34	39	8	2.4	39.9	52.8	4.8	0.1
Harbor International/ HAINX	0.79	35	11	1.3	20.6	67.4	9.2	1.6
Fidelity Diversified International/ FDIVX	1.02	32	6	1.1	24.4	59.3	2.2	12.9
American Funds Capital World/CWGIX	0.71	33	8	0.7	15.7	51.7	5.5	26.4

*As of Oct. 12; multiyear returns are annualized Data: Morningstar

STOCKS

LOOKING PAST EARNINGS

By Ben Levisohn

Last quarter, 73% of Standard & Poor's 500-stock index companies beat profit expectations, and this earnings season should offer more of the same. Of the 14 companies that reported earnings from Sept. 28 through Oct. 9, 12 made more money than analysts' best guesses. But knowing positive surprises are on the way doesn't make picking winners any easier. Of the 12 companies that surpassed their numbers, half saw their shares fall during the next trading session. Even big gainers Walgreen, Jabil Circuit, and Nike, which all saw shares climb more than 7%, are not sure long-term bets. "There's too much focus on current earnings," says Karl Mills, manager of the large-cap CounterPoint Select Fund. "It's what you can glean about the future that's important." Here's how some money managers are parsing recent earnings reports.

WALGREEN | Welcome Back?

THE MOVE Investors sent shares of Walgreen up 9.2% on Sept. 29 when it reported earnings of 44¢ a share, 5¢ better than expectations.

THE BACKSTORY It wasn't just beating estimates that boosted shares. A year ago, Walgreen acknowledged that its costs had become bloated and laid out a plan that included cutting expenses by $1 billion and lowering the number of store products. Ever since, investors have been looking for signs of a turnaround. Early results were ugly. Cutting the product mix meant unwanted inventory had to be sold at deep discounts. Gross margins, which had been falling, kept plummeting.

THE OUTLOOK Margins finally turned positive this quarter, and Walgreen said 70% of the inventory cutback is complete. With 30% to go, margins should keep rising. "This quarter is further evidence that the turnaround will bear fruit," says Jason Tauber, a vice-president with Neuberger Berman's Large Cap Disciplined Growth group, which owns the stock.



Data: Bloomberg

JABIL CIRCUIT | Great Expectations

THE MOVE Jabil investors anticipated good things coming into its Sept. 29 earnings announcement. The circuit board manufacturer didn't disappoint: Jabil made 16¢ a share, doubling the consensus view of 8¢. Revenues were $2.8 billion, beating the consensus by $150 million. The stock rose 12.3% on Sept. 30.

THE BACKSTORY Jabil said that next quarter's sales would top $3 billion, $120 million more than analysts had expected and that earnings would be 24¢ to 32¢ a share, well above predictions. Even contribution margins—the profit made from each sale once fixed costs are subtracted—topped predictions at 19.7%. "Investors didn't expect them to hit these numbers for four more quarters," says Credit Suisse Group analyst William Stein.

THE OUTLOOK For Jabil's streak to continue, its customers, including Cisco Systems and Hewlett-Packard, have to do well. So Andrew Corn, chief investment officer for equities at Beacon Trust, is watching earnings reports closely. (He isn't ready to buy the stock just yet.) Those reports will go a long way toward predicting whether the company can repeat its performance next quarter—and whether Beacon will be buying. "The big news is that they beat on revenues," Corn says. "But is that growth sustainable?"



Data: Bloomberg

NIKE | Just Doing It

THE MOVE At first glance, Nike's earnings report wasn't very impressive. Sure, profits came in at $1.04 a share, 7¢ better than the consensus. But revenues dropped 12%, and the number of orders it expects to fill in the next quarter dropped 6%. After digesting the news overnight, investors sent shares up 7.7%.

THE BACKSTORY Those numbers are an overall improvement. Future orders had dropped 12% last quarter, while North American clothing sales fell 8.8%, an improvement over last quarter's 15.4%.

THE OUTLOOK Be cautious, says Stephen K. Shueh, managing partner at Princeton (N.J.)-based Roundview Capital. Investors know Nike's business is improving, and its 63.68 price reflects a reasonable valuation relative to its current profits. | BW |



Data: Bloomberg



DELTA WEATHERS THE STORM

It has been a while since an airline stock hit the top of the Street's favored list, but the world's largest carrier, Delta Air Lines (DAL), is beating the odds. Of 13 major analysts who track Delta, 12 rate it a buy, and one tags it hold. What sets Delta apart from rivals is not just its lean cost structure and aggressive cuts in overseas capacity but also the boost to its profit outlook from the October 2008 merger with Northwest Airlines. These factors make Delta an attractive buy, says Daniel McKenzie of Next Generation Equity Research, despite the shares' fast climb to 9.06, up from a 52-week low of 3.51 on Mar. 6. The stock is still below its 52-week high of 12.65 on Jan. 6, he notes, trading at about 4.5 times its earnings before interest, taxes, depreciation, amortization, and aircraft rental expense. McKenzie says it deserves to trade at 6 times earnings, or 14 a share, barring a sharp spike in oil prices. His target of 14 is based on his forecast that Delta will earn $1.20 in 2010 and $1.55 in 2011.

Standard & Poor's Jim Corridore, who rates Delta a buy, says the merger gives the airline increased scale and big synergies on costs. Helane Becker of Jesup & Lamont, also a bull, says bookings and pricing are better than they have been all year. She sees Delta earning $1.13 a share in 2010 on sales of $33.9 billion, vs. an estimated loss in 2009.

DELTA GOT A LIFT FROM NORTHWEST



Data: Bloomberg

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Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

TIFFANY'S SPEEDY REBOUND



Data: Bloomberg

New Sparkle At Tiffany

Shares of Tiffany (TIF) vaulted to a 52-week high of 41.75 on Oct. 14, up from 16 on Mar. 6, as analysts saw fresh shine at the retailer of fine jewelry, even amid a weak economy.

Tiffany is focusing more on smaller store formats offering "lower-priced, higher-margin products that have enhanced productivity," reports Zacks Investment Research, which rates Tiffany outperform. To stop sales erosion, Tiffany has reduced its workforce and new-store openings. Zacks forecasts Tiffany will earn $1.73 a share on revenues of $2.5 billion in 2009 and $2.04 on $2.7 billion in 2010, vs. 2008's $2.34 on $2.8 billion.

Kimberly Greenberg of Citigroup says Tiffany may gain from widespread liquidation of other jewelers and store closures—starting in the fourth quarter, when consumer spending should stabilize. She expects the stock to hit 50 in a year.

A RISING TIDE AT PROCTER & GAMBLE



Data: Bloomberg

P&G Is Set To Bubble Up

Procter & Gamble (PG), No. 1 in consumer products, is supposed to be the ultimate defensive enterprise for weathering hard times. But sales in fiscal 2009 ended June 30 slid 3%, with flat operating-profit margins. This has restrained the stock's rise: It's at 57.33, up from a low of 43 on Mar. 9.

But Edwin Walczak of investment bank Vontobel, which owns shares, sees P&G at 73 in a year. Part of the trouble, he notes, was that the company upgraded the quality of its top products, such as Tide and Pampers, and this meant raising prices. But Walczak foresees earnings of $4.25 a share in 2011, compared with $4.14 in 2010 and $4.26 in 2009.

Douglas Lane of investment company Jefferies, who rates P&G a buy, says it's also more attractive now because of restructuring, accelerated investment spending, and new CEO Robert McDonald. | BW |

BRAD TRENT; CHARTS BY DAVID FOSTER

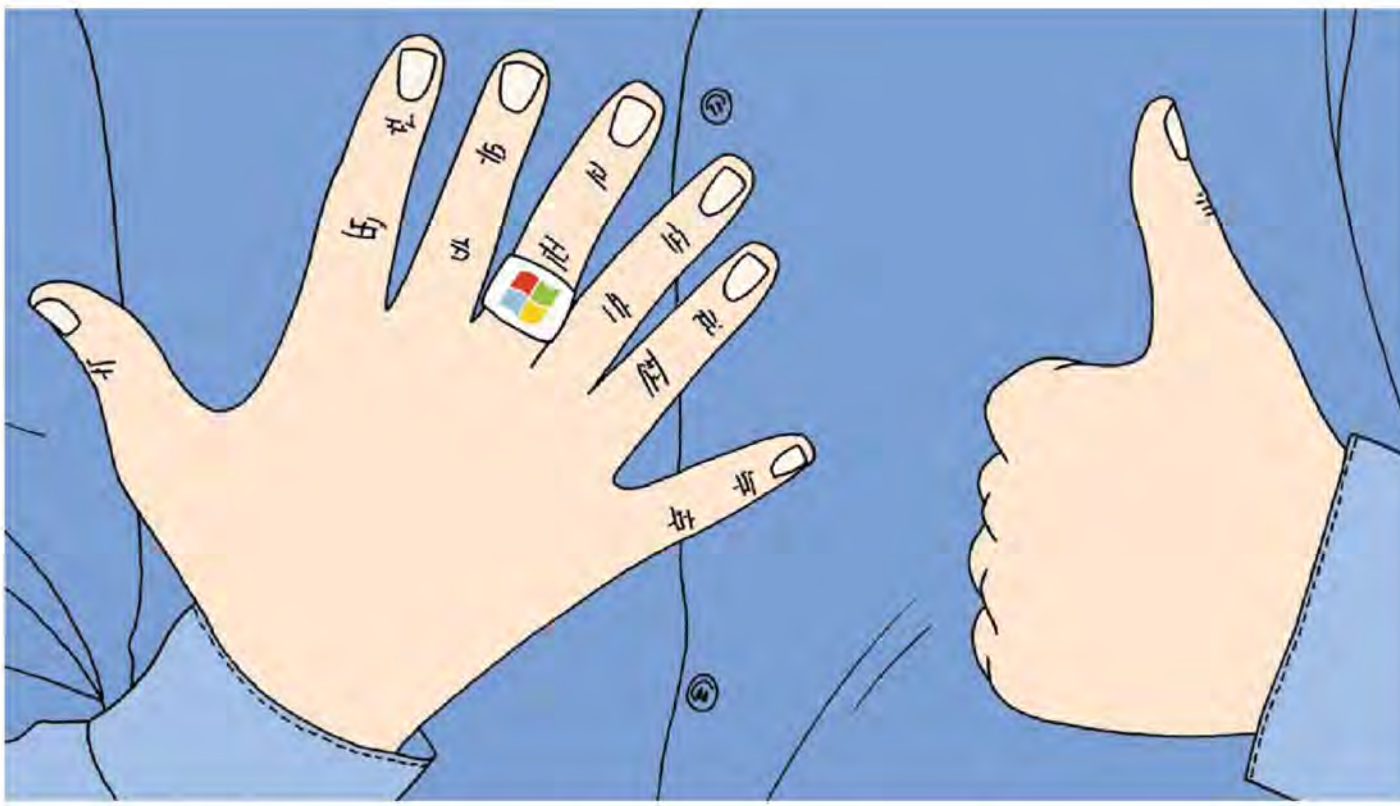
073 Outside Shot: End the debit card free-for-all
076 Books: Blinded by optimism

TECH & YOU | STEPHEN H. WILDSTROM



Win 7: Microsoft Gets It Right (Finally)

The operating system is fast and loaded with smart features—unlike the disastrous Vista



As the Oct. 22 launch of Windows 7 nears, the Microsoft marketing machine is running at a frenzied pace. No, Windows won't make your kids cuter or transport you to a magic land where unicorns romp, as in the TV ads. But as software goes, Win 7 is a big deal. If you're running Vista, you should plan to spend $120 or so for an upgrade. And if you have an older PC running Windows XP, then maybe this launch is a good excuse to think about a replacement.

The innards of Win 7 are little altered from Vista, other than offering a welcome boost in performance. It's nice to see an operating system from Microsoft that's less demanding of hardware resources than its predecessor. More important, Win 7 solves a large number of quirks that made Vista annoying and adds some very polished features that make the program easier to use.

I've been running the final version of Win 7 on my main PC since Microsoft finished the software at the end of July. My positive first impression has grown stronger as I've used it. There are few compatibility problems—Microsoft has delivered on the promise that if an app runs on Vista, it will run on 7—and it boots up significantly faster and performs more snappily than Vista.

I'll bet it's been a while since you heard anyone wax poetic about a task bar, right? Well, Microsoft redesigned this little strip at the bottom of the screen that serves as your control

BRAD TRENT; ILLUSTRATION BY PETER ARKLE

THE LONG ROAD TO WIN 7

WINDOWS 98



1998 An updated Windows 95 with much-improved networking features and support for laptops. It was hobbled by crashes and suffered from weak security.

WINDOWS 2000



2000 A solid product, but one only intended for corporate use. Poor power management and accessory support made it a bad choice for laptops.

WINDOWS MILLENNIUM EDITION



2000 Designed as a consumer stopgap pending the release of the delayed Windows XP, ME was widely reviled during its 10-month life span.

WINDOWS XP



2001 A consumer- and laptop-friendly version of Windows 2000. Security problems were eased by a 2003 update. This is still the most widely used version of Windows.

WINDOWS VISTA



2007 Ambitious in design but cursed in development, many of its most interesting planned features were dropped before release. Consumers disliked it and corporations shunned it.

center, and it's one of the most engaging elements in this upgrade. Unlike its predecessor, the new version shows icons only for programs currently running and any others you, not Microsoft or other software publishers, choose to keep there permanently. Each running program is represented by a single icon. Hold the mouse over that icon and you'll see thumbnail images of each window the program has open. Move the pointer to one of the thumbnails, and a full-size version appears. Click, and it becomes the active window.

If you right-click on a task-bar icon instead, you get a "jump list," a menu of choices specific to that program. For example, right-click an Internet Explorer or Google Chrome icon, and you get a list of frequently visited pages. Other menu choices let you reopen a recently closed window or create a blank window.

SOMETHING BORROWED

Of course, few good ideas are entirely new. In the grand tradition of computer innovations, this task bar is an improved version of the Mac OS X Dock, which itself borrowed heavily from an earlier version of the Windows task bar. I found that this and other design features took a bit of getting used to, but they soon felt both natural and more efficient.

Windows 7 also fixes the "system tray," that jumble of icons at the far right corner of the task bar that harasses you by announcing events such as routine updates that you didn't need to know about. The new "notification area" lets you control which icons appear and what they notify you about.

Device Stage is an oddly named but useful feature that provides a simple, visual interface for controlling printers, scanners, and other add-on devices. It's up to the device manufacturers to implement it, so it isn't available for all products, but I'm sure it will become ubiquitous.

Setting up a networked printer has always been a black art in Windows, but now it's about as easy as on a Mac (page 28). Click "Add a printer" and the choices on a home or office network appear on a list. Choose the one you want, and it's ready to use within a minute or two. If you have a laptop that you bring home from work, you can set it up so that it automatically switches default printers when you move between home and office. A new feature called HomeGroup makes it much easier to share files, printers, and other resources on a home network, but only among systems running Win 7.

One downside to the new version is that certain familiar applications are missing. Microsoft has been under pressure from European antitrust enforcers to unbundle applications from its operating systems, so it has removed Movie Maker, Photo Gallery, and, most important, Mail (known as Outlook Express on Windows XP). Fortunately, improved versions of all three are available as free downloads.

I'm going to go out on a limb and say Microsoft has relearned the importance of listening to users. If you are one of the computer owners who had to up your dose of blood pressure meds after switching to Vista, I think you're in for a pleasant surprise. Even XP diehards might want to reconsider their loyalty to an eight-year-old operating system that is showing its age badly, especially in networking and security. It has been a long wait for something truly better, but I think we have arrived. |BW|

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Virtual Tour

There's a lot more to Windows 7 than can be described in an article of this length. And for many of the new features, pictures are a lot more useful than words. In the Windows section of its own Web site, Microsoft provides a wealth of graphical information including screen shots and videos of new features, along with tutorials.

For pointers to this page and other articles on the topic, go to **bx.businessweek.com/windows-7/reference/**

OUTSIDE SHOT | LLOYD CONSTANTINE

Let's End the Debit Card Fee-for-All



The Fed stopped onerous fees on checks in 1913. It could now do the same for e-checks

Of late, a spotlight has fallen on the wide range of fees charged annually to consumers who use debit cards. News stories and congressional inquiries have brought to light the extent to which lucrative overdraft charges, for example, are being collected. "Prepaid" debit cards with maintenance and inactivity fees, among many others, have also attracted attention. And to avoid spurring legislation that would control the fees they set, certain large banks, such as JPMorgan Chase, Wells Fargo, and Bank of America, have voluntarily altered some of these practices.

But these disclosures and countermoves are a sideshow. Now that the dominance of debit-card transactions is inevitable—today they far surpass transactions with credit cards—the $20 billion question has to do with their oversight, or lack thereof. It's a job that clearly should fall to the Federal Reserve, which was established on Christmas Eve in 1913 to supervise America's payment system (then primarily cash and checks). That system had a serious problem then, and it's cropping up again.



Nearly a century ago banks routinely discounted checks from rivals. If a New Yorker paid a store in San Francisco with a $100 check drawn on her Chase account, the store might only get $95 because its bank—Bank of America, say—would discount that "foreign" check. This became a huge problem for stores, shoppers, and banks, and these fees, called "exchange charges," were a major stumbling block to the growth of interstate commerce. The Fed was in large part designed to stop this madness.

It did its job, and exchange charges vanished. Banks were forced to honor each other's checks "at par." A $100 check was again worth $100.

This rule and Fed oversight worked splendidly for the next 70 years, until the 1980s, when debit-card transactions started to replace cash and checks. By and large, this shift was a good thing. Consumers could conveniently tap their bank accounts using plastic. Stores were relieved of the hassle of handling cash and checks. Banks certainly preferred the higher security of electronic transfers to the expensive processing and clearing of checks.

The Fed noticed this shift and debated extending the at-par clearance rule for checks to electronic debit transactions. That made sense since debit-card transactions were nothing more than electronic checks. But the Reagan-era Fed never acted. In the regulatory vacuum, two debit systems developed. Cards branded with NYCE, STAR, MAC, PULSE, Shazam, and other network names were used with a PIN, and, like checks, cleared at par. But Visa or MasterCard debit cards required a signature. When that happened, the transactions were tagged with a so-called interchange fee, effectively restoring pre-Fed exchange charges.

Stores couldn't avoid these fees because they were forced to accept the Visa/MasterCard debit transactions if they wanted to take Visa or MasterCard credit cards—which were, and remain, the primary line of credit in the U.S. The Visa and MasterCard debit cards, designed to look like credit cards, also fooled a great many consumers, resulting in overdrafts and bounced checks.

This ended in 2005 after a long but successful lawsuit brought by Wal-Mart Stores and the Limited on behalf of 5 million stores—disclosure: I was lead counsel for the retailers—that forced Visa, MasterCard, and the banks to "untie" the acceptance of debit from credit and print "Debit" on every one of the hundreds of millions of Visa and MasterCard debit cards. But that left, to this day, the unresolved issue of regulating interchange fees.

Last year banks collected more than $20 billion in interchange fees on debit transactions, and that number is rising fast. You might ask, why? After all, debit cards enable banks to sidestep the expense of processing checks or cash. Interchange fees can be accurately called many unpleasant names. I'll use a euphemism economists prefer: They're a "transfer of wealth" from U.S. stores and shoppers to banks.

The Fed's original mandate gives it power to end this practice. Now that the country recognizes that everything government does is not necessarily bad and all that business does is not necessarily good, it's time the Fed did the job it was given and still has the authority to perform: supervising America's payment system. |BW|

Lloyd Constantine is a founding partner of law firm Constantine Cannon and author of the recent book Priceless: The Case that Brought Down the Visa/MasterCard Bank Cartel.

Jack and Suzy Welch are off while Jack recovers from a back infection.



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Blinded by Optimism—From 9/11 to Subprime

Barbara Ehrenreich says American positivity is a "mass delusion" partly to blame for the nation's recent ills

In 2000, Barbara Ehrenreich was "optimistic to the point of delusion" when it came to First World health care. Then she was diagnosed with breast cancer. It was during this emotional nadir that she slammed into the positivity police, the crowd of upbeat delusionals she accuses of rebranding cancer from a health crisis into an "opportunity of a lifetime," a "passport to the life you were truly meant to live," and "a makeover opportunity" (enabled by scalpel-happy plastic surgeons). When Ehrenreich's insurance company informed her that they regarded her biopsy as an "optional indulgence," she took to her keyboard, posting a rant on a cancer chat board with the subject header "Angry." Almost immediately, she says, a rosy mob was upon her, scolding her for her "bad attitude" and imploring her to "run, not walk, into counseling." God forbid you can't get with the Pink Ribbon.

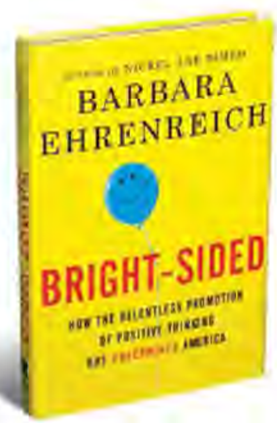
Bright-Sided: How the Relentless Promotion of Positive Thinking Has Undermined America is the author's book-length examination of the booming, sparkly industry that she believes has been spawned by the positive-psychology movement. In chapters that consider the roots of American optimism, the business of motivation, the "God wants you to be rich crowd," and more, the author skewers what she sees as the source of the Panglossian puffery that is afoot in America today. A reckless and religious spread of positive thinking, argues Ehrenreich, has turned into a "mass delusion," the "ideology" and "tyranny" partly responsible for U.S. vulnerability on September 11, the Iraq War, the grim aftermath of Hurricane Katrina, and the subprime mortgage collapse. Demon Positivity also exists in a symbiotic relationship with capitalism. Why else, Ehrenreich argues, would employees put up with more hours, less pay, and fewer benefits—especially when it's so obvious that the corporate master class is rigging the game? Positivity: the apologist for brute market forces.

Like her best-selling *Nickel and Dimed*, a study of the Brechtian horrors of working-class life, *Bright-Sided* is insightful, smart, and witty. Unfortunately, the author stumbles when she dismisses the serious academic research into happiness and positive thinking. This includes neuroscience that shows how the brain regulates our emotions.

Ehrenreich's penultimate chapter is titled "How Positive Thinking Destroyed the Economy." It's hardly as simple as that. But she makes important points about what happens to those who dare to warn of the worst. In pre-subprime America, delivering the news that we were all burning down the house was a career-ender. Nowhere was this more true than on Wall Street. One such martyr to the cause of financial realism, Ehrenreich writes, was Mike Gelband, who ran the real estate division of Lehman Brothers. Gelband warned Lehman CEO Dick Fuld about the real estate bubble in 2006. "Fuld promptly fired the misfit, and two years later, Lehman went bankrupt."

Ehrenreich notes the danger to those who voice doubt, including a Lehman exec whose subprime warning got him fired

Ehrenreich is right to argue that we would be better off if we put more of our energy into social change—into attacking problems head-on rather than dismissing them. Too often, the self-help movement's nothing-is-real thinking is siphoning off energy that could be going into attacking substantive issues, including the mounting evidence that cancer's causes are environmentally related and connected to everyday products that are filled with carcinogens.



***Bright-Sided: How the Relentless Promotion of Positive Thinking Has Undermined America* by Barbara Ehrenreich; Metropolitan Books; 235 pp; $23**

But it is simplistic of Ehrenreich to brand decades' worth of academic study as total claptrap, as she does in a chapter titled "Positive Psychology: The Science of Happiness." At this point the body of evidence drawn from research into positivity and happiness is too vast, too long-standing, and too persuasive to be dismissed with a Swiftian savaging. Psychologists have revealed valuable insights into what makes us truly happy (spending time with friends and family, practicing gratitude, volunteering) and what doesn't (liposuction, commuting, and the lottery). Positivity (and its cousin, optimism) has been scientifically linked to better health, less depression, and longer life. These are benefits available to everyone. And they are free.

So, yes, bring on the vigilant realism. Trust, but verify. Just don't imagine that empiricism has to cancel out optimism—or negate hope. | BW |



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